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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

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Annual Compliance Report, 2014	)	Docket No. ACR2014
	)	

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
INITIAL COMMENTS ON THE UNITED STATES POSTAL SERVICE
FY 2014 ANNUAL COMPLIANCE REPORT
(February 2, 2015)

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On December 29, 2014, the United States Postal Service ("USPS") filed its "United States Postal Service FY 2014 Annual Compliance Report" ("ACR"), which is required by 39 U.S.C. § 3652(a) to be filed within 90 days after the end of the fiscal year. On December 31, 2014, the Postal Regulatory Commission ("Commission") issued Order No. 2313, "Notice of Postal Service's Filing of Annual Compliance Report and Request for Public Comments," seeking initial comments by February 2, 2015, and reply comments by February 13, 2015. The Commission's Annual Compliance Determination ("ACD") is expected on March 27, 2015, pursuant to 39 U.S.C. § 3653(b).

Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. (hereinafter "Valpak") hereby submit these joint Initial Comments on the FY 2014 ACR in response to the Commission's Notice.

COURSE OF PROCEEDINGS

The Commission issued Order No. 2313, commencing proceedings in this docket, and inviting:

> public comment on the Postal Service's FY 2014 ACR and on whether any **rates or fees in effect during FY 2014** (for products individually or collectively) were **not in compliance** with applicable provisions of chapter 36 of title 39 (or regulations promulgated thereunder). Commenters addressing market dominant products are referred in particular to the applicable **requirements** (39 U.S.C. 3622(d) and (e) and 3626); **objectives** (39 U.S.C. 3622(b)); and **factors** (39 U.S.C. 3622(c))....
>
> The Commission also invites public comment on the **cost coverage matters the Postal Service addresses in its filing**; service performance results; levels of customer satisfaction achieved; and such other matters that may be relevant to the Commission's review. [Order No. 2313, p. 5 (emphasis added).]

On January 23, 2015, Valpak filed a Motion for Issuance of Information Request, seeking additional information related to Standard Mail Flats and negotiated service agreements ("NSAs"). As of the filing of these comments, the Commission has not issued the proposed information request.

I. POSTAL SERVICE FINANCES REMAIN DEEPLY TROUBLED DESPITE SHOWING SOME IMPROVEMENT IN FY 2014.

The Commission's most recent analysis of Postal Service finances re-emphasized its understanding of a fundamental business truth:

> **availability of cash** through operating revenues and debt[1] is the **most important requirement** of any business organization. Without the ability to **generate sufficient cash** from business operations, or to access sufficient debt capacity **to invest** in the business, an organization **cannot continue to operate.** [Postal Regulatory Commission, "Promoting financial transparency: Analysis of United States Postal Service Financial Results and 10-K Statement for Fiscal Year 2013" (rev'd Apr. 10, 2014) (hereinafter "2013 ACD Financial Analysis"), p. 17 (emphasis added).][2]

The Commission correctly recognizes that gross revenues are of no benefit to future continued operations if they are consumed entirely by current operating expenses. Thus the Commission's discussion of Postal Service finances properly focuses its attention on the critical items of liquidity, net revenues, and cash provided by profits.

> The inability to **generate sufficient cash** also has affected long-term investment. As the Commission noted in the FY 2012 ACD, the Postal Service had reduced capital spending in order to conserve cash. The Commission stated that if this situation continued, important assets would deteriorate and could cause increases in maintenance costs and potentially impact service performance. [In] the Exigent Rate Request … the Commission noted that continued **low levels of liquidity** which impairs the Postal Service's ability to invest in needed capital is significant to the entire postal system. [*Id.* (emphasis added).]

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[1] The Postal Service reached its statutory debt limit in 2012 and is thus precluded from additional borrowing.

[2] The Commission was quoting from its FY 2011 ACD. http://www.prc.gov/Docs/89/89576/2013%20Financial%20Analysis%20Report.pdf

These Commission comments reflect a better understanding of the Postal Service's business than does the Postal Service manifest in its pricing decisions. As these comments will demonstrate, the Postal Service has for many years appeared to put priority on maintaining mail volume and generating gross revenue — regardless of the profitability of that mail. Yet it is profitability which is critical to the organization's ability to make capital investments and continue operating in a sustainable manner. This section of these comments addresses Postal Service profitability, changes in its liquidity in FY 2014, and whether a foundation has been laid for profitability, liquidity, and investment in FY 2015 and the years thereafter.

A. The Postal Service Generated Positive Operating Profits in FY 2014.

The Postal Accountability and Enhancement Act of 2006 ("PAEA") required the Postal Service to pre-fund the Retiree Health Benefits Fund ("RHBF") by $56 billion over 10 years following enactment. As a result, ever since 2006, the Postal Service has reported a large annual loss. Last year was no exception. In FY 2014, the RHBF charge of $5.7 billion caused the Postal Service to report a net operating loss of $5.5 billion (Table I-1). This charge was an accrual item, however, and since it was not actually paid, had no effect on the Postal Service's operating profits or liquidity.[3]

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[3] Presentation of large but unpaid RHBF obligations in the Postal Service's financial statement can obscure basic financial trends.

Table I-1
Summary Cost and Revenue Analysis
FY 2014
($, millions)

	Revenues	Attributable Costs	Coverage
Market Dominant:			
Mail Products			
First-Class	29,408.1	13,280.3	221.44%
Standard	17,496.7	10,534.0	166.10%
All Other	2,625.5	3,059.6	85.81%
Services	2,060.1	1,331.1	145.77%
Subtotal	51,590.4	28,205.0	182.91%
Competitive Products:			
Mail	14,584.9	10,611.4	137.45%
Services	695.1	358.5	193.89%
Subtotal	15,280.0	10,969.9	139.29%
Other (non-attributable)	984.0	34,187.0	
Total	67,854.4	73,361.9	
Net Loss, as reported		-5,507.5	

Source: Public Cost and Revenue Analysis, FY 2014.

In FY 2014, less than 60 percent of Postal Service costs were attributed to products. Table I-1 shows that total attributable costs amounted to **$39,174.9** million, and represented 58.6 percent of all mail-related revenue.[4] As a result, the Postal Service had an enormous pot of institutional costs to extract from mailers. Although First-Class Mail and Standard Mail[5]

4 Mail-related revenue was $66,870.4 million, which equals Total Revenue ($67,854.4 million) less Other Revenue ($984.0 million).

5 Of course, aggregate Standard Mail profits conceal losses from the two unprofitable Standard Mail products, most especially the $460 million in losses from Standard Flats.

were profitable, the "All Other" products category in the table had a cost coverage of only 85.8 percent. The deeply underwater Periodicals class accounted for 62 percent of "all other" revenue and was the major source of the reported deficit (*see* the FY 2014 CRA for additional details).

The Postal Service continues to grow its cumulative billions of dollars of losses on underwater products (*see* Table V-1, *infra*). That these losses continue is evidence that the Postal Service does not agree with the Commission's comments about the importance of the bottom line, but rather has a laid-back and distinctly unbusinesslike approach to pricing underwater products.[6] Realizing that it was not living within its means, as indicated by its perilously low liquidity, the Postal Service filed for an exigent price increase. In Docket No. R2013-11, the Commission approved an exigent increase of 4.3 percent that took effect on January 26, 2014, in the form of a temporary surcharge, to provide the Postal Service with additional revenue of $3.2 billion.

When the Postal Service's reported net loss is adjusted to remove the RHBF charge, as well as other non-cash charges, the result is what the Postal Service now correctly describes as its "Controllable income (loss)." As shown in Table I-2, the Postal Service had controllable income of $1.374 billion in FY 2014.

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[6] While the class-based price cap impeded the Postal Service in making CPI-based pricing adjustments, it did not constrain pricing decisions in exigent pricing dockets. In the most recent exigent pricing docket, Docket No. R2013-11, the Postal Service gave underwater Periodicals an average increase — demonstrating that it has no inclination to set prices in a businesslike manner.

Table I-2
Postal Service Controllable Income (Loss)
2012 – 2014
(millions)

2012	$(2,465)
2013	$(1,004)
2014	$ 1,374

Source: 2014 Report on Form 10-K, p. 14.

The Postal Service's FY 2014 controllable income of $1.374 billion was provided to a substantial extent by virtue of the 4.3 percent exigent price increase, which generated additional revenues of $1.4 billion (hereinafter "exigent revenues") from its date of implementation on January 26, 2014 through September 30, 2014. *See* 2014 Report on Form 10-K, p. 51. Helped by that exigent revenue of $1.4 billion in FY 2014, and **excluding** the $5.7 billion RHBF charge, but including other miscellaneous non-cash items, the Postal Service managed to achieve a profit of $193 million (*see* Table I-3, adjustment at bottom). Thus, without the exigent price increase, the Postal Service would have approximately broken even in FY 2014.

The Postal Service's reported liquidity position is further evidence that its financial condition has improved, at least temporarily. In 2014, the Postal Service reduced its cash outlays for investment and finally managed to save some of that available cash flow.[7] That, coupled with the 2014 operating profit, enabled cash and cash equivalents to increase by $2.6

[7] *See* p. V-13, note 2, *infra*.

billion from September 30, 2013 to September 30, 2014. 2014 Report on Form 10-K, p. 50. Consequently, it is fair to say that at the end of FY 2014 the Postal Service's financial condition was somewhat improved from the end of FY 2013.

Table I-3
Cost and Revenue Analysis Excluding RHBF Charge
FY 2014
($ millions)

	Revenues	Attributable Costs	Coverage
Market Dominant:			
Mail Products			
First-Class	29,408.1	13,280.3	221.44%
Standard	17,496.7	10,534.0	166.10%
All Other	2,625.5	3,059.6	85.81%
Services	2,060.1	1,331.1	145.77%
Subtotal	51,590.4	28,205.0	182.91%
Competitive Products:			
Mail	14,584.9	10,611.4	137.45%
Services	695.1	358.5	193.89%
Subtotal	15,280.0	10,969.9	139.29%
Other (non-attributable)	984.0	34,187.0	
Total	67,854.4	73,361.9	
Pro Forma Adjustments:			
Deduct RHBF Charge	.	-5,700.0	
Adjusted Totals	67,854.4	67,761.9	
Pro Forma Profit (loss) excluding RHBF charge		192.5	

The Commission rejected the Postal Service's request that the exigent price increase continue forever, and in the coming months the U.S. Court of Appeals for the D.C. Circuit should issue its opinion. Thus, the Postal Service cannot count on maintaining additional exigent revenue throughout FY 2015.

Table I-4
Cost and Revenue Analysis Excluding RHBF Charge and Exigent Revenue
FY 2014
($ millions)

	Revenues	Attributable Costs	Coverage
Market Dominant:			
Mail Products			
First-Class	29,408.1	13,280.3	221.44%
Standard	17,496.7	10,534.0	166.10%
All Other	2,625.5	3,059.6	85.81%
Services	2,060.1	1,331.1	145.77%
Subtotal	51,590.4	28,205.0	182.91%
Competitive Products:			
Mail	14,584.9	10,611.4	137.45%
Services	695.1	358.5	193.89%
Subtotal	15,280.0	10,969.9	139.29%
Other (non-attributable)	984.0	34,187.0	
Total	67,854.4	73,361.9	
Pro Forma Adjustments:			
Deduct Exigent Revenue	-1,400.0		
Deduct RHBF Charge	.	-5,700.0	
Adjusted Totals	66,454.4	67,761.9	
Pro Forma Profit (loss) excluding Exigent Revenue and RHBF charge		-1,307.5	

Table I-4, *supra*, supports the Postal Service's observation that:

> The Postal Service's **liquidity could be challenged** if the temporary exigent rates expire. **Diversion of hard copy mail**

> **continues to reduce revenue.** [2014 Report on Form 10-K, p. 51 (emphasis added).]

At a time such as this, the Postal Service should be doing absolutely everything in its power to unburden itself of unprofitable products and cut costs,[8] but for the reasons discussed in these comments, it has continued to operate more like a government agency with an entitlement to be bailed out from its mistakes by the court, the Commission, or the Congress to avert cessation of service, rather than a business enterprise which could suffer the rigors of reorganization in bankruptcy.

B. In FY 2014, the Postal Service Again Failed by a Wide Margin to Maximize Contribution.

The Postal Service represented to the reviewing U.S. Court of Appeals for the District of Columbia in the appeal of the FY 2010 ACD that it is pursuing one central financial goal:

> The Postal Service's **goal** at this time in its history must be **to maximize contribution,** not reduce it. [Brief of Petitioner U.S. Postal Service in Docket No. 11-1117, U.S. Postal Service v. Postal Regulatory Commission, 676 F.3d 1105 (D.C. Cir. 2012) (emphasis added).]

Sadly, the Postal Service has failed to use its pricing flexibility in a way that would enhance its finances as represented to the court. Indeed, it has taken virtually no steps toward "maximizing contribution." In fact, and in almost complete contrast with the above statement to the court, the Postal Service stoutly defends low price increases on, as well as losses incurred by, underwater products. Without any question, those low price increases and losses have materially reduced contribution and liquidity. At the same time, and perversely, such

[8] Valpak incorporates by reference its discussion of cost cutting from its Valpak Initial Comments, Docket No. ACR2013 (Jan. 31, 2014), pp. 74-82.

practices allow an unfair burden to be imposed on its most profitable customers. The Postal Service consistently sends the wrong price signals to mailers. And the Commission — despite rhetoric about profitability and liquidity in its 2013 ACD Financial Analysis — has refused to order meaningful remedial actions, allowing this practice to continue for many years.

By its own actions, in FY 2014 the Postal Service again failed by a wide margin to "maximize contribution" available to it **within the price cap** — *i.e.*, the price cap does not constitute anywhere near the constraint on contribution that the Postal Service would have the Commission or Congress believe. Contribution could have been — and can be — increased within the price cap by the Postal Service altering its pricing policies to focus on earning contribution, eliminating losses, and generally being more businesslike; *see* Section IV.C, *infra*, for elaboration on the Valpak Standard Mail contribution maximizing model.

The exigent rate increase imposed in FY 2014 gave the Postal Service a major opportunity to permanently reduce some of the most glaring pricing imbalances in its tariff structure. Instead of so doing, however, it opted for an across-the-board increase. The result was no movement whatsoever towards improved price signals, which indicates that within the foreseeable future the Postal Service does not intend to implement any major improvement in the tariff schedule. The exigent rate request increase thus exemplifies the Postal Service's utter failure to demonstrate that it has any real intention of faithfully pursuing what it claims to be its goal.

C. As a Government Agency, the Postal Service Has No Competency in Business-Like Pricing.

The Postal Service has asserted that its core competency is in the operation of accepting, sorting, transporting, and delivering mail,[9] and Valpak agrees. The Postal Service did not identify any core competency in making pricing decisions, nor could it. In the area of pricing in ways which violate PAEA (*see*, *e.g.*, Section IV.B, *infra*), the Postal Service is entitled to no deference from the Commission. It is long past time for the Commission to exercise its regulatory powers, perform its statutory role, and prevent the Postal Service from either destroying the rate cap regime or self-destructing.

Under the rate cap as implemented by the Commission, Postal Service operations clearly have not been self-sustaining. The exigent rate increase may have given the Postal Service a temporary reprieve. Nevertheless, regardless of how the D.C. Circuit rules, the Postal Service's financial picture is again on the brink of needlessly allowing its finances to slide downhill, back into a non-sustainable status (*see* Section V, *infra*). Postal Service pricing adjustments deliberately encourage continuing losses on underwater products, and those decisions inevitably have received Commission approval (provided only that rate cap is not exceeded and statutory workshare discount provisions are observed). Repeatedly, the Postal Service has failed by a wide margin to come anywhere close to maximizing contribution available under the price cap. Thus far, that seems to have been of little concern to the Commission, which provides no meaningful checks and balances, despite having noted that

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[9] L. Steven, "New Postmaster's Goal: Act Like Private Sector," *Wall Street Journal* (Nov. 23, 2014) http://www.wsj.com/articles/new-postmasters-goal-act-like-the-private-sector-1416788696.

"the Postal Service's current financial situation calls into question its long-term viability." 2013 ACD Financial Analysis, Executive Summary.

Ineffective pricing seems built into the Postal Service's culture. Although beset by a variety of problems, the Postal Service only has itself to blame for its current lack of liquidity and backlog of needed investments. The Postal Service needs to effect major pricing changes. Until that occurs, it appears unlikely that the Postal Service ever will be able to operate in a truly self-sustaining mode (*see* Section V.C, *infra*). As it is currently being allowed to operate, the Postal Service soon could cease to be a viable enterprise, incapable of fulfilling its Universal Service Obligation.

II. UNDER PAEA, THE COMMISSION HAS THE DUTY TO REVIEW PRICING DECISIONS BY THE POSTAL SERVICE — A GOVERNMENT-PROTECTED MONOPOLY — AND TO ISSUE REMEDIAL ORDERS DESIGNED TO ENSURE THAT ILLEGAL PRICING IS FULLY AND RAPIDLY CORRECTED.

The Postal Service is justifiably proud of its long history, its role in binding the country together (39 U.S.C. § 101(a)), the fact that it is mentioned in the U.S. Constitution (Article I, Section 8, Clause 7), and its status as a government agency with numerous benefits derived from that status. 39 U.S.C. § 201. The Postal Service has a budget of $65 billion, while the Commission has a budget of $100 million. The Postal Service has approximately 490,000 career employees, plus another 130,000 non-career employees,[10] while the workforce of the Commission is closer to 100. The Postal Service antedates the Commission by two centuries. For all these reasons, the Postal Service considers itself the senior partner in the area of postal decision making, and it chafes under any modicum of regulation emanating from the Commission. The Postal Service has come to appeal virtually every decision made by the Commission with which it disagrees, and disagreements seemingly occur with ever growing frequency. Postal Service legal fees are paid for by users of the mail, so its litigation strategy seems to be, "There is no downside to challenging the Commission."[11]

[10] 2014 USPS Annual Report to Congress, p. 68.

[11] Most recently, the Commission's decision not to add a new competitive product for round-trip DVD and disc mailings over which it would exercise too much market power, since no other company offers that service, was challenged by the Postal Service in federal court. *See* A. Medici, "Postal Service sues to create new product for DVD mailings," Federal Times, (Jan. 23, 2015) http://www.federaltimes.com/story/government/management/oversight/2015/01/23/postal-service-prc-mailing/22230021/.

Yet the Postal Service is the only known government agency that is not trusted by Congress to exercise rulemaking authority without being subject to the authority of another government agency. And, on the flip side, the Commission is the only known government agency with the primary responsibility to supervise another government agency. With such an unusual structure, it periodically becomes necessary to re-calibrate and return to basics — *e.g.*, to examine and understand the nature of the Postal Service and the Commission's role as regulator of pricing for market dominant products. The Commission was never intended to stand idly by and permit illegal Postal Service pricing to continue, despite the preferences of those who want the regulator to defer to the regulated, employing only "light-handed" regulation.

A. Congress Has Conferred on the U.S. Postal Service Monopoly Protection, a Status which Can Be Expected to Lead to Abusive Pricing.

The modern era began with the Postal Reorganization Act of 1970, the law which created the U.S. Postal Service out of the old Post Office Department. That law established the Postal Service as "an independent establishment of the executive branch of the Government of the United States." 39 U.S.C. § 201.

Congress has conferred on the Postal Service two monopolies, and many other statutory benefits and preferences.[12] A group of federal laws and regulations — known collectively as the Private Express Statutes — gives the United States Postal Service a monopoly over the carriage of what has been defined to constitute "letter-mail." *See* 18 U.S.C. §§ 1693-1699.

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[12] *See generally* U.S. Postal Service, Universal Service and the Postal Monopoly: A Brief History (Oct. 2008). http://about.usps.com/ universal-postal-service/universal-service-and-postal-monopoly-history.pdf

Another federal law prohibits private persons from using mailboxes without postage.[13] 18 U.S.C. § 1725. PAEA intended for the Postal Service to make decisions in a business-like manner. By definition, however, market dominant products do not operate in a competitive market, and it was never intended that the Postal Service have unrestrained freedom to set prices for those products, especially when the prices are set in an almost totally unbusiness-like manner.

Under 39 U.S.C. § 3622, and the regulatory scheme developed by the Commission under 39 C.F.R. part 3010, the Governors have the authority to notice price adjustments, subject to what the Commission now views to be a minimalist review, ensuring only that the CPI cap is adhered to, limitations on worksharing discounts are complied with, and little more, despite extensive provisions concerning pricing. 39 U.S.C. § 3622(b), (c), (d), and (e).

Indeed, the Postal Service is given a measure of "pricing flexibility" (39 U.S.C. § 3622(b)(4) and (c)(7)). That pricing flexibility, however, may be exercised only within the confines of Title 39, Commission regulations, and Commission review. "Pricing flexibility" was not intended to mean that prices set by the Postal Service are entitled to deference. Postal Service pricing is lawful only if it complies with Title 39 — and determining compliance is a responsibility that is vested in the Commission, not on the Postal Service.

The Postal Service has come to claim that its "business model" is broken because it does not have unfettered pricing discretion. It thus supports proposals to have Congress

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[13] Although several rationales for these monopolies have been propounded, the primary reason probably is to prevent cream-skimming by competitors, so that the Postal Service can generate extra revenue which would be used to support its Universal Service Obligation.

authorize still more pricing authority — at the expense of the Commission's authority. *See, e.g.*, S. 1486 (113th Congress). However, Congress has not enacted any such laws changing pricing responsibility. In truth, the "business model" of the Postal Service would be broken beyond repair if it were given its wish of unfettered pricing authority, as that would lead to further politicization of the pricing process, with the Postal Service having even greater power to grant or withhold favors to favorite mailers in whatever manner it chooses.[14]

B. Under 39 U.S.C. § 3622(c), the Commission Has a Duty to Ensure that Postal Service Prices Comply with the Various Requirements of Title 39 and to Remedy Violations of Law.

In PAEA, Congress defined the nature of the Postal Regulatory Commission by tracking the same language used to define the U.S. Postal Service: "an independent establishment of the executive branch of the Government of the United States." 39 U.S.C. § 501. The Commission was given rulemaking authority and authority to "take any other action they deem necessary and proper to carry out their functions and obligations to the Government of the United States and the people as prescribed under this title." 39 U.S.C. § 503. Among those functions was ensuring the legality of Postal Service pricing.

Under PAEA, Postal Service products were divided into two categories. The first category is "market-dominant" products (primarily First-Class Mail and Standard Mail), which generally were those subject to postal monopolies, where the Postal Service possessed market power over its customers which could be abused. The second category is "competitive"

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[14] *See, e.g.,* Section III, *infra*, regarding Standard Flats; Section V, *infra*, regarding all underwater products; and Section VI, *infra*, regarding negotiated service agreements.

products, where the Postal Service does not have market power over mail users, because these products are not protected by a monopoly, and the market provides some discipline over potentially abusive pricing decisions by the Postal Service. The Commission was given lesser authority over competitive products, but vast authority to prevent abusive pricing for market-dominant products.

Congress required the Postal Regulatory Commission to conduct, *inter alia*, an annual review of the Postal Service's compliance with the policies of Title 39 because it knew that it could not confer monopoly status on the Postal Service and leave it free of regulation. *See* 39 U.S.C. § 3653(b). It also empowered the Commission to hear complaints. *See* 39 U.S.C. § 3662. In either case, the Commission was given the same broad, remedial powers to correct any illegal pricing.

Particularly with respect to market-dominant products, the Postal Service is not entitled to deference from the Commission regarding its compliance with Title 39 simply because it is a government agency. Because of its status as a regulatory agency, a federal court might defer to the Commission's judgment on certain matters. However, when an independent review is required, the Commission fails to do its job if it simply defers to the supposed "judgment" of the Postal Service.

Under PAEA, the Commission and the Postal Service are certainly not "partners," as is often said. Indeed, there is danger in informal *ex parte* contacts occurring between the Commission and the Postal Service. The Commission is "the regulator" (indeed, the Commission's name was changed in PAEA to confirm this role), and the Postal Service is "the regulated."

Congress entrusted the Commission with the power not only to conduct reviews and write reports, but also once a problem is found it then was charged with **the duty to order the Postal Service to remedy violations of law**.[15] 39 U.S.C. §§ 3653(c) and 3662(c).

C. The Commission's Remedial Order in Docket No. ACR2010, as Implemented by the Postal Service, Has Been Ineffective and Matters Have Gotten Worse.

In its FY 2010 ACD, the Commission found that the Postal Service's pricing of Standard Flats violated 39 U.S.C. § 101(d) and issued a remedial order. FY 2010 ACD (Mar. 20, 2011), p. 106. The Commission determined that the compelled cross-subsidization of Standard Flats by other products "reflects an unfair and inequitable apportionment of the costs of postal operations to all Standard Mail users…. [and that the] Postal Service has failed to utilize the pricing flexibility granted to it by the PAEA to address this issue…." *Id.* Thus, the Commission ruled that other Standard Mail users, including Valpak, illegally were charged too much, while Standard Flats users illegally were charged too little.

At the time the Commission made its finding and issued a remedial order based on FY 2010 data, the cost coverage of Standard Mail Flats was **81.6 percent**, and the product's unit loss was **8.2 cents**.[16]

Now, in FY 2014, **four ACR dockets** later, after **four years** of supposed Postal Service "compliance" with the Commission's remedial order,

- the cost coverage of Standard Flats is **unchanged — 81.59** percent, and,

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15 *See* Gamefly v. PRC, 704 F.3d 145 (D.C. Cir. 2013).

16 *See* FY 2010 ACD, p. 103.

- the unit loss is **much worse** — 11 percent worse — **9.1 cents**.

Total losses have shrunk from **$577** million[17] to **$460** million, but only because the volume of Standard Flats decreased by approximately 2 billion pieces, from 7.068 billion to 5.054 billion. Clearly, the Commission's remedial steps cannot claim credit for the reduction in total losses resulting from lower volume. To compare apples to apples, if those 2 billion pieces were still being mailed, total losses in FY 2014 would be $642 million.

Lest the significance of these shocking Standard Flats numbers be overlooked, they are repeated in Table II-1.

Table II-1
Standard Flats Contribution (Loss)
FY 2010 versus FY 2014

	FY 2010	FY 2014	Comparison
Cost Coverage	81.6%	81.59%	Unchanged
Unit Contribution	(8.2 cents)	(9.1 cents)	Much worse
Total Contribution	$577 million)	($470 million)	Better (due only to 2.0 billion in volume reductions, or would have been loss of $642 million)

With the benefit of the last four years of hindsight, sufficiency of the Commission's remedial steps in FY 2010 ACD must be reviewed. Those remedial steps were as follows:

> Pursuant to section 3653(c), the Commission **directs** the Postal Service to **increase the cost coverage** of **the Standard Mail Flats product** through a

17 *See* FY 2010 ACD, p. 102.

combination of **above-average price adjustments**, consistent with the price cap requirements, and **cost reductions** until **such** time that the **revenues** for this product **exceed** attributable **costs**.

* * *

Within 90 days of the issuance of the FY 2010 ACD, the Postal Service shall present a **schedule** of future **above-CPI price increases** for Standard Mail Flats….

* * *

In subsequent ACRs, the Postal Service shall **report** the following information:

- describe all **operational changes** designed to reduce flat costs in the previous fiscal year and estimate the financial effects of such changes;

- describe all **costing** methodology or measurement improvements made in the previous fiscal year and estimate the financial effects of such changes;

- a **statement** summarizing the historical and current fiscal year subsidy of the Flats product; and, the estimated **timeline** for phasing out this subsidy.

In subsequent Notices of Market Dominant Price Adjustments, the Postal Service shall **report** the following information:

- an explanation of how the proposed prices will move the Flats cost coverage toward 100 percent, and

- a statement estimating the effect that the proposed prices will have in reducing the subsidy of the Flats product. [FY 2010 ACD, pp. 106-07 (emphasis added).]

Assessing these remedial steps generally, price increases — except for the 4.3 percent across-the-board exigent price increase — have been little more than CPI increases. Costs, on the other hand, have increased by CPI or more, due to the very nature of Standard Flats and how they must be processed and delivered, and show no sign of improvement. Costing methodology changes have had negligible effect, indicating that costs are being accurately reported, and there never has been a schedule to phase out the subsidy within a reasonable period of time, such as two or three years.

Of course, the Postal Service has stoutly resisted even the Commission's mild remedial steps. The Postal Service appealed the Commission's finding and order, filing a Petition for Review. On April 17, 2012, the D.C. Circuit upheld the Commission's finding and remedial order, only remanding to the Commission for "definition of the circumstances that trigger § 101(d)'s failsafe protection, and for an explanation of why the particular remedy imposed here is appropriate to ameliorate that extremity." U.S. Postal Service v. Postal Regulatory Commission, 676 F.3d 1105, 1109 (D.C. Cir. 2012).

On remand, the Commission affirmed its remedial order and provided the explanation required by the court. *See* Order No. 1427. Following that, in Order No. 1472, the Commission confirmed the termination of a partial stay,[18] and ordered the Postal Service to provide the information required by the FY 2010 ACD as well as to provide the schedule of above-CPI price increases with its FY 2012 ACR.

The intervening years have brought continued Postal Service resistance to the Commission's remedial order, coupled with passivity by the Commission in enforcing its order both in Annual Compliance Reviews and Pricing Dockets. The Appendix to these Comments contains a detailed review of (i) the Postal Service's filings in each of its Annual Compliance Reports for FY 2011, FY 2012, and FY 2013, each of the Commission's Annual Compliance

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[18] During the pendency of the appeal, the Commission had stayed a portion of its order: the requirement that the Postal Service provide a schedule of above-CPI price increases. *See* Order No. 739.

Determinations, and (ii) the Postal Service's filings in each of its Pricing Notifications for Docket Nos. R2012-3, R2013-1, R2013-10, R2013-11, and R2015-4, and the Commission action on each.

Under the ACD 2010 remedial order, there have been winners and losers. Users of Standard Flats have been the obvious winners. Total losses from Standard Flats during the **five years** from FY 2010 to FY 2014 have been **$2.606 billion**.[19] It is no wonder that these favored mailers have become so agitated when other mailers, who have had to pay higher rates to make up for these losses, object. And as an extra penalty, avoidance of Standard Flats losses could have obviated the need for the Postal Service's exigent price increase on all mailers in January 2014.

In one real sense, as a government agency, the Postal Service has been protected from its own pricing folly. All persons responsible for this distinctly unbusinesslike pricing have continued to receive their salaries, and no doubt many have received bonuses as well. And now the Postal Service complains to Congress about financial losses suffered because its "business model" is broken, demanding even more flexibility with respect to pricing and degradation of service to fix it. The Postal Service never tells Congress that its own pricing decisions are a direct cause for a substantial portion of these losses, and that with greater pricing flexibility it would be free to make even more unbusinesslike decisions — such as incurring even greater losses on underwater products and NSAs.

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[19] Standard Flats losses over **eight years** have amounted to an astounding **$3.456 billion**. *See* Table III-1, *infra*.

To understand the terribly unfair and inequitable effect of what has occurred, one need only return to how the D.C. Circuit described circumstances in FY 2010:

> **Standard Mail Flats**… --were in **violation of 39 U.S.C. § 101(d)'s mandate** [and] current rates "reflect[ed] an **unfair and inequitable** apportionment of the costs of postal operations of all Standard Mail users…." [T]he **persistent losses** incurred by Standard Flats amounted to a **subsidy of Flats at the expense of other Standard Mail products (and their customers)**, whose rates it saw as being artificially inflated in order to make up the difference. [U.S. Postal Service v. PRC at 1106 (emphasis added).]

Valpak is one of the customers of other Standard Mail products to which the court was referring. As users of the one major product that pays the highest coverage in Standard Mail — HD/Saturation Letters — Valpak has been one of the losers from such Postal Service pricing practices. It is time for this abusive pricing to end. With the demonstrated inadequacy of the Commission's remedial order in its FY 2010 ACD and its subsequent enforcement of that order, the central question in this docket is:

> Shall the Commission issue a further remedial order requiring the Postal Service to rapidly and substantially increase prices for Standard Flats, offset by reductions in price to products with the highest coverages, led by High Density/Saturation Letters?

Valpak submits that the answer is obvious — the Commission can, it should, and it must.

III. STANDARD MAIL FLATS ARE NOT IN COMPLIANCE WITH PAEA, REQUIRING FURTHER REMEDIAL ORDER FROM THE COMMISSION.

Subsection A, *infra*, sets out the spiraling losses from Standard Flats in both FY 2014, and on a cumulative basis. Subsection B, *infra*, addresses the inherently high, and growing, cost of handling of Standard Flats. Subsection C, *infra*, re-examines the findings and assumptions made by the Commission in its FY 2013 ACD to justify its prior decision to issue no further remedial order.

A. Standard Mail Flats Losses Increased in FY 2014.

The Commission initially determined in its FY 2010 ACD that the Standard Mail Flats product was in violation of 39 U.S.C. § 101(d) when it lost $582 million in one year. It initiated remedial steps. Even with those remedial steps, however, and a loss of 2.0 billion pieces over this period, that one product again lost **$460 million** in FY 2014. This FY 2014 loss represents a **one-year increase in loss** from this one product of a remarkable **$80 million — 21 percent** — over the **$380 million** loss in FY 2013. *See* Table III-1.

Amazingly, the Postal Service has given no indication it is uncomfortable with its approach to its pricing of Standard Mail Flats, despite its huge and growing investment needs (*see* Section V.C, *infra*). The Postal Service also appears to care little if hundreds of millions of dollars were lost in FY 2014. The Postal Service asserts that it has "pricing flexibility," and that it should be able to do what it wants. However, under PAEA the Commission must do more than express concern about such losses in its FY 2014 ACD. It needs to take strong remedial action to stop the financial hemorrhaging.

And the Postal Service appears to care little about the cumulative sum of money it has lost over a multi-year period. Since 2008, when the Postal Service first reported data using the new product categories under PAEA, Standard Mail Flats has lost almost **$3.5 billion**. Regardless of Postal Service insensitivity to the problem, the Commission must be concerned about such losses under PAEA.

Table III-1
Standard Mail Flats Subsidies

Fiscal Year	Subsidy (millions)
2008	$228
2009	$622
2010	$582
2011	$652
2012	$532
2013	$380
2014	$460
Total:	$3,456

The Postal Service quite believably states that these losses on Standard Flats will continue. Under its pricing approach, it concludes that Standard Flats will need to be subsidized for at least the next two years: "it is unlikely that the shortfall will be eliminated by the end of 2016…." Postal Service Supplemental Information (Jan. 15, 2015), p. 3. The Postal Service's limited two-year time horizon is completely arbitrary, supposedly based on the provision requiring Commission re-examination of the price-cap system in 2017. In fact, there is no reason to believe that this hemorrhage will abate ever if the Postal Service is allowed to exercise unfettered “pricing flexibility” in violation of Title 39. Of course, very much unlike a business, Postal Service management suffers not one whit from these losses. Postal Service decision makers are completely insensitive to the fact that losing money on Standard Flats requires the Postal Service to charge more to other market dominant product mailers than otherwise — an abusive exercise of the kind of power which a monopolist has over its customers.

Catalogers who pay artificially low prices love to have their mail costs subsidized by others. Their arguments to continue the subsidy are transparent. They care as little about other mailers as does the Postal Service. And, if the Postal Service is allowed to exercise its supposed pricing expertise in an unregulated fashion, there is no end in sight to the favoritism of certain mailers, and the abuse of other mailers.

Those responsible for pricing do not even appear to care that the Postal Service cannot make necessary capital investments (*see* Section V.B, *infra*). The end will come, however, when Postal Service losses cripple its operations and a bailout is needed from some source. A bailout was already allowed by the Commission with the exigent price increase — where all mailers suffered because of Postal Service product losses on a few favored products. Other bailouts are on the horizon if the Commission does not act.

B. The Unit Cost of Standard Flats Failed to Decline in FY 2014, as Valpak Predicted, and No Meaningful Cost Reduction Appears in the Offing.

In Docket No. ACR2013, Valpak commented that it was unrealistic to expect any future meaningful reduction in the unit cost of Standard Flats. Valpak Initial Comments, pp. 63-74. Specifically, Valpak opined:

> it is possible that, to date, the FSS deployment has had no effect on the end-to-end unit cost of flats, and it may even have caused a slight increase. [*Id.*, p. 73.]

Cost data submitted in this year's ACR show a substantial **increase in the unit cost** of Standard Flats of **9.4 percent**, or **5.6 cents**.[20] Valpak's prior prediction concerning the unit cost of Standard Flats thus turns out to have been conservatively understated. It now appears quite possible that full deployment of FSS machines to date has had no effect on the end-to-end unit cost of Standard Flats. In fact, processing on FSS machines may even have caused a slight increase in unit cost.

The Postal Service has gone to considerable length in an effort to explain what it refers to as "the *unexpected* increase in the costs as reported in the FY2014 CRA for Standard Mail Flats.... The attached [explanation by USPS] takes as given the Standard Mail Flats costs reported in the FY 2014 CRA."[21] *Id.* (emphasis added). For reasons explained below, the **5.6 cent increase** in the unit cost of Standard Flats, although claimed to be unexpected by the Postal Service, may not be nearly so aberrational as the Postal Service seems to presume.

Hopefully, the unit cost of Standard Flats will not increase further in FY 2015. Nevertheless, a further increase in unit cost should be regarded as a distinct possibility for reasons discussed herein. Last year's ACD went overboard with unwarranted rosy speculations about imminent decreases in unit cost and improvements in coverage of Standard

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[20] From 43.8 cents to 49.4 cents. *See also* ChIR No. 2, Q. 6 and ChIR No. 3, Q. 3.

[21] Notice of the United States Postal Service of Filing Partial Supplemental Information in Response to Order No. 2313 (Jan. 15, 2015), p. 2.

Flats. *See* Section III.C, *infra*. The fact that the cost of handling Standard Flats has increased faster than other Standard Mail products is certainly no reason to mitigate price increases for Standard Flats. By now, it should be clear that the Postal Service cannot handle Standard Flats as inexpensively as it can letter-shaped and other Standard Mail products, despite FSS deployment. Proper price signals need to be given to advertisers which reflect postal costs. At this juncture, Standard Flats are inherently a high-cost product, and prices for that product, like all products, need to cover those costs, whatever they may be. In this year's ACD, it would be a welcome change to see the Commission's discussion focus rather on the reality of high Standard Flats costs rather than continuing to base decisions on the sheer hope they someday change.

Valpak is aware of and appreciates the Postal Service's assiduous efforts being made to control the cost of flat-shaped mail even before the FY 2014 CRA Report was filed on December 29, 2014. *See* "USPS Needs a Plan B for Flat Mail, Coalition Says," deadtreeedition.blogspot.com/2014/3/usps-needs-plan-b-for-flat-mail.html. Nevertheless, the fact is that the unit cost of flats has not decreased, and the price is removed from covering cost further than ever. Although it may be considered reasonable under the circumstances for flat-shaped mail to be temporarily relieved from making even a token contribution to the Postal Service's extensive institutional costs, Standard Flats nevertheless should, at a minimum be charged their attributable cost, without delay.

If the Commission desires the system of rate cap regulation which it devised under the authority granted in PAEA to achieve success — where "success" is evidenced by noticeable improvement in the Postal Service's financial condition under its rate cap, including more liquidity, and greater profitability and contribution — it needs to assert its regulatory authority and order a price increase for Standard Flats that will fully eliminate the subsidy within two years, by the time the Commission's 10-year review of PAEA is due. Otherwise, that review could be forced to acknowledge that rate cap regulation, at least as devised and implemented by the Commission, is a failure as regards eliminating cross-subsidies and overcoming Postal Service efforts to frustrate the system.

C. The Commission Based Its Decision to Order No Further Remedial Action in Docket ACR2013 on Findings which Are No Longer Operative.

In Docket No. ACR2013, the Commission devoted fully 10 pages — by far the largest single section of its FY 2013 ACD — to an analysis of Standard Flats. *See* FY 2013 ACD, pp. 45-55. Based on that analysis, the Commission decided to take no action on Standard Mail rates: it declined to order that prices for Standard Flats be increased, with corresponding reductions in prices for other Standard Mail products (especially HD/Saturation Letters[22]) which have been forced to pay higher rates for years so the Postal Service could indulge its desires to subsidize Standard Flats.

In its FY 2013 ACD, the Commission discussed Standards Flats from every perspective: (i) unit losses, (ii) total losses, (iii) trends, (iv) the Commission's finding of a violation of 39 U.S.C. § 101(d) in its FY 2010 ACD, (v) the Commission's remedial order in its FY 2010 ACD, (vi) the Postal Service's unsuccessful challenge to that order, (vii) the Postal Service's reluctance to comply with the remedial order, (viii) projections for the

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[22] For a discussion of the adverse pricing effect on Saturation Letters in recent dockets, *see* Section V.B, *infra*.

product, (ix) an evaluation of comments filed discussing the product, (x) an evaluation of the Valpak Standard Mail contribution model, and (xii) a discussion of the effect of losses from Standard Flats. *Id.*, pp. 45-53. In the end, the Commission made a finding, and a conclusion based on that finding:

> ***progress*** *is being made towards addressing the issues raised by the Commission in the FY 2010 ACD. As a result,* ***no further remedial action*** *is required at this time.* [FY 2013 ACD, p. 54 (emphasis added).]

Valpak urges the Commission to perform a **new analysis** of these same "issues raised by the Commission in the FY 2010 ACD" and make a **new finding**, based on **new information** — repeating the same process it followed last year. Then, the Commission will see that what the Commission viewed as "progress" in FY 2013 has become "regress" in FY 2014. Indeed, most of the Commission's almost Panglossian speculation at that time has now proven to have been unrealistically sanguine. In order to demonstrate just how incorrect the Commission's analysis has turned out to be, this section sets out in full the Commission's Analysis on Standard Flats, together with commentary and updates on developments that have occurred since that analysis was published at the end of March 2014. Based on recent developments explained in the commentary interspersed below, it is submitted that the Commission must now act aggressively to remedy the Postal Service's continued violation of 39 U.S.C. § 101(d) that the Commission originally found in FY 2010. In the face of developments discussed herein, continued failure to act at this time would be arbitrary and capricious.

What the Commission labeled "Analysis" of Standard Mail Flats in its FY 2013 ACD is reproduced below in full,[23] which has been annotated with updates and comments:

Commission Analysis

Although a **significant cost coverage shortfall** still exists in FY 2013, it is **not growing**.

> *Update*: The Commission-perceived trend has been reversed dramatically. The "significant cost shortfall still exists," but it is growing, and growing rapidly. Compared to last year, in FY 2014 the cost coverage **shortfall grew from 14.9 to 18.4 percent**. **Cost coverage fell** from **85.1 percent**[24] in FY 2013 to **81.6 percent** in FY 2014.

The combination of **above-average price increases** for Standard Mail Flats in Docket No. R2013-1, a **decrease** of 2.8 percent in **unit cost** per piece from 46.5 cents in FY 2012 to 45.2 cents in FY 2013,

> *Comment*: The Commission's characterization of the Docket No. R2013-1 price increase for Standard Mail Flats (effective on January 27, 2013) as being "above-average" is technically accurate, but highly misleading. Whereas the average Standard Mail price increase was **2.569 percent**, the increase for Standard Mail Flats was only slightly (almost infinitesimally) above that — **2.617 percent**. Order No. 1573, p. 3.

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[23] FY 2013 ACD, pp. 53-55; bolding added; italics original; footnotes omitted.

[24] Cost coverage was reported to be **85.1 percent** in the FY 2013 ACD. However, cost coverage is now reported to have been slightly less, **84.9 percent** in the FY 2013 ACR's RPW Report, USPS-FY14-42.

Update: Again, the Commission-perceived trend has been reversed. In FY 2014, **unit cost increased by more than three times the amount it declined in FY 2013 — 9.3 percent**, from 45.2 cents in FY 2013 to 49.4 cents in FY 2014.

and a decrease of 6.2 percent in **volume** from 5.94 billion pieces in FY 2012 to 5.6 billion pieces in FY 2013

Update: In FY 2014, the Postal Service was fortunate that volume decreased further from 5.6 billion pieces in FY 2013 to 5.17 billion pieces. Only by such fortuitous volume decreases has the severity of the financial wound inflicted on the Postal Service by Standard Flats been mitigated slightly.

resulted in a **loss of $376 million** in FY 2013.

Update: Again, the Commission-perceived trend has been reversed. The FY 2014 **loss increased to $460 million**. The spike in losses from this one product is truly remarkable when one considers that it occurred in the face of a substantial decline in volume.

This is an **improvement of $152 million** over FY 2012, and is the second fiscal year that Standard Mail Flats has improved its contribution and reduced its cost coverage shortfall.

Update: Again, the Commission-perceived trend has been reversed. FY 2014 saw **deterioration in contribution of $84 million** and a decrease in coverage of 3.5 percent.

Comment: Every single pricing and costing trend which the Commission cited at this point in its Analysis to rationalize inaction in its FY 2013 ACD has been reversed in the FY 2014 ACR.

In FY 2013, the Postal Service has continued to undertake various **operational changes** to make Standard Flats processing **more efficient**.

> *Update*: To the extent that, in its FY 2013 ACD, the Commission deferred further remedial steps in reliance on Postal Service assurances of "operational changes" to make processing of Standard Flats "more efficient," the FY 2014 ACR demonstrates that this was a mistake, and one which must not be repeated. Even though the Postal Service undertook aggressive cost cutting steps, the Postal Service's verbal assurances as to results have been proven empty and unreliable. Indeed, the cost-cutting measures that the Commission relied on in FY 2013 were not just unsuccessful — they were a spectacular failure. To the extent that **unit cost** is a reflection of efficiency, the unit cost of Standard Flats increased by 9.3 percent in FY 2014 — evidencing a **serious setback in efficiency**. In its comments last year, Valpak anticipated this growth in the unit cost of handling Standard Flats, based on the very nature of Standard Flats, but they were wholly disregarded by the Commission. *See* Valpak Initial Comments, Docket No. ACR2013, pp. 63-73, which are incorporated herein by reference. In its FY 2014 ACD, it would be reckless for the Commission to rely yet again on Postal Service representations about aggressive cost cutting of Standard Flats and to defer performing its statutory duty.

In conformance with the FY 2010 ACD directive, the Postal Service presents a schedule of future Standard Flats **price increases** of at least CPI x 1.05 in 2015 and 2016. These measures **may prevent cost increases from outpacing price increases**, which in turn, **may decrease the shortfall**.

*Comment #*1: The Postal Service's supposed remedial price increases of CPI x 1.05 have been demonstrated to be paltry indeed. If CPI is 2.0 percent, CPI x 1.05 results in a 2.1 percent price increase — only **0.1 percent more than an average increase**. Such an increase indicates that the Postal Service is attempting to avoid any meaningful compliance with the Commission's directive in FY 2010 ACD — and the Commission has allowed the Postal Service to give such bare minimalist, not meaningful, price increases, for years. A 0.1 percent additional increase barely allows Standard Flats to keep pace with increases in average cost, and, as discussed *supra*, costs have increased well above average for Standard Flats. In this docket, the result of such ***de minimis*** **remedial pricing** clearly has been revealed to be **totally ineffective**. The D.C. Circuit has ruled that once the Commission determines that there has been a violation of statute, its remedy must completely resolve the statutory violation. *See* Gamefly v. Postal Regulatory Commission, 704 F.3d 145, 149 (D.C. Cir. 2013).

Comment #2: The Commission employed the word "**may**" twice in the preceding sentence describing the Postal Service's "concession" to increase Standard Flats pricing barely above CPI. Repeated use of the word "may" indicates that the Commission knew it was speculating based on its hope that Postal Service prognostications could be relied upon. The Commission certainly must not do so again.

Update: Quite the opposite from what the Commission anticipated has occurred. As discussed *supra*, the total shortfall from Standard Flats has grown from **$380 million** to **$460 million**. The unit cost of Standard Flats increased by 9.3 percent, while unit revenue, including the exigent price increase, went up by 5.2 percent.

The **unit contribution gap** between Standard Mail Letters and Standard Mail Flats, and between Standard Mail Carrier Route and Standard Mail Flats, has continued to decrease in FY 2013.
The **gap** between Standard Mail **Letters** and Standard Mail **Flats decreased** from 17.5 cents in FY 2012 to 16.2 cents in FY 2013.

Update: Again, the Commission-perceived trend has been reversed. In FY 2014, this **gap increased** from 16.2 to 19.4 cents.

Similarly, the **gap** between Standard Mail **Carrier Route** and Standard Mail **Flats decreased** from 14.7 cents in FY 2012 to 13.1 cents in FY 2013.

Update: Again, the Commission-perceived trend has been reversed. In FY 2014, this **gap increased** from 13.1 to 16.7 cents.

In addition, the **gap** between Standard Mail **High Density and Saturation Letters** and Standard Mail **Flats decreased** from **16.5 cents** in FY 2012 to **14.9 cents** in FY 2013,

Update: Again, the Commission-perceived trend has been reversed. In FY 2014, this **gap increased** from 14.9 to 17.6 cents.

and the **gap** between Standard Mail **Flats** and Standard Mail **High Density** and **Saturation Flats and Parcels decreased** from 17.9 cents in FY 2012 to 16.4 cents in FY 2013.

Update: Again, the Commission-perceived trend has been reversed. In FY 2014, this **gap increased** from 16.4 to 19.1 cents.

Comment: Frankly, decisive remedial action for Standard Flats is required irrespective of the relative intra-class pricing trends relied on by the Commission in FY 2013. Standard Flats is losing serious money and financially impairing Postal Service liquidity, and the hemorrhaging of money must be addressed despite trends in these intra-class price relationships. However, since the Commission believed these decreases to have been significant in FY 2013, the fact that each and every one of these trends has been reversed, and every "gap" comparison cited by the Commission worsened in FY 2014, also must be viewed as significant. Since the narrowing of the price gaps was considered a legitimate rationale for issuing no further remedial order, then the expansion of these price gaps must now be treated as yet another reason for issuing a further remedial order.[25]

In response to the Commission's FY 2010 ACD directive, the **Postal Service has taken steps** to address the cost coverage shortfall. In FY 2013, the Postal Service made improvements with regard to cost and revenue.

Update: Again, the Commission appears to have been relying on the Postal Service speculation about "improvements with regard to cost and revenue." However, unit costs increased far more quickly than the tiny increases in unit price noticed by the Postal Service. As a result, in FY 2014, the cost coverage shortfall worsened significantly. It should be clear that the Commission no longer can rely passively on such "steps" taken by the Postal Service.

Nonetheless, some **commenters** argue that the Postal Service has not done enough to curb the shortfall and that the steps it has taken are inadequate to close the cost coverage gap in a reasonable time.

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[25] Should the Commission chose to reverse field and use the expansion of these price gaps to justify inaction, the Administrative Procedure Act would require that it set out a principled rationale for a reversal of position. Mfrs. Rw'y Co. v. Surface Transportation Board, 676 F.3d 1094, 1096 (D.C. Cir. 2012).

Comment: Here the Commission shifts to a discussion of the comments. In retrospect, it appears that the Postal Service has done all it can to cut costs but certainly has not done much to raise prices. The problem now, of course, is that the Commission has not done enough. The **cost coverage gap will never be closed** under the current remedial order. The Postal Service and its profitable customers continue to be harmed financially. Further remedial action is necessary, now.

The Commission notes that the Postal Service has taken **remedial steps** to address the cost coverage shortfall, and as indicated above, the **cost coverage gaps are decreasing**. If implemented, the **schedule of price increases** presented by the Postal Service coupled with cost changes below CPI-U **would lead** to continued improvement.

Update: In FY 2014, despite any and all remedial steps taken by the Postal Service, the cost coverage gap increased and worsened significantly, as discussed *supra*. The schedule of inadequate price increases has not worked. The percentage change in Standard Flats unit cost far exceeded the percentage change in the CPI-U x 1.05. The Commission's remedial order, as minimally complied with by the Postal Service, has proven woefully insufficient.

The Commission finds that progress is being made towards addressing the issues raised by the Commission in the FY 2010 ACD. As a result, no further remedial action is required at this time.

Update: This sentence constitutes the Commission's central finding on Standard Mail Flats. In view of the analysis above, any similar finding by the Commission this year would be arbitrary and capricious. The Commission does not again have the discretion to take "no further remedial action … at this time."

According to the Postal Service, while it has described the new and ongoing steps it has taken during FY 2013 to make its processing of Flats more efficient, "[n]o analysis has been performed to **isolate the cost savings** resulting from these initiatives, assuming that such analyses are even possible with available data." *See* Response to CHIR No. 2, question 1. Generally, cost savings programs or initiatives target one or more specific activities to produce cost savings. These programs should have specific, **measurable targets** by which the benefits of the program can be evaluated. The Postal Service establishes similar targets in the form of performance goals in its Annual Performance Plans and Reports under 39 U.S.C. 2803 and 2804.

The Commission remains concerned that the Postal Service has **not quantified the cost savings from operational changes** designed to reduce Standard Mail Flats costs.

> *Update*: The Postal Service continues to be unable to quantify cost savings from operational changes, if any. However, whatever they may have been, it is a certainty that any such cost savings have been more than offset by major cost increases. The Commission's expression of "concerns" does not in any way allow the Commission to decline yet again to implement a stronger remedial order.

To assist the Commission's review, it recommended in the FY 2012 ACD that "the Postal Service derive elasticity estimates to provide for a more realistic assessment of the impact of price changes on contribution." FY 2012 ACD at 116. The Postal Service indicated that for each quarter in which new data became available, it estimated both aggregate and disaggregated shape-based (letters and non-letters) Standard Mail equations with the additional data. According to the Postal Service, "the disaggregated shaped-based equations have still not yielded results which would suggest that substituting the disaggregated elasticity estimates for the aggregate estimates would generate better forecasts or otherwise improve the assessment of the impact of price changes on contribution."

The Commission appreciates the Postal Service's efforts to derive elasticity estimates as recommended in the FY 2012 ACD. Having these elasticity estimates would provide for a more realistic assessment of the impact of price changes on volume and total contribution. Therefore, the Postal Service should continue its efforts to derive elasticity estimates for Standard Mail products.

> *Comment*: The Commission compliments the Postal Service for "efforts to derive" product elasticity estimates.[26] Of course, there is no evidence that the Postal Service uses elasticity estimates in pricing decisions. Therefore, it is impossible to tell if the Postal Service wants to develop product elasticities. In fact, the Postal Service may not want to develop product elasticities for fear that the Commission might employ them in a closer examination of pricing decisions. Without product elasticity estimates, the Postal Service has had virtually unregulated pricing authority, and it may not want to lose that control.[27]

In conclusion, Valpak urges, *inter alia*, the Commission to **repeat the same Analysis of Standard Flats that it performed in its FY 2013 ACD**, and reaching the opposite conclusions as it must, to issue a **supplemental remedial order** that will be effective in preventing unfairly low rates for users of Standard Flats and unfairly high prices for users of other Standard Mail products, most especially HD/Saturation Letters.

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[26] During FY 2014, the Commission staff presented a paper (by Cigno, *et al.*), presented in Docket No. RM2014-8, attachment to Order No. 2117, which used a novel methodology that enabled the authors to claim that they have developed robust estimates of elasticities for individual postal products. At the same time, however, the authors stated that their results generally confirmed previous results presented by the Postal Service. For a further discussion of elasticity, *see* Section IV.C, *infra*.

[27] In its FY2012 ACD, the Commission stated: "The usefulness of both models [including Valpak model] would be significantly improved if estimates of own-price elasticity of demand were available by product." *Id.*, p. 116. Is it reasonable to believe that the Postal Service would voluntarily provide the very data that the Commission said would "significantly improve" the Valpak analysis, when the Postal Service does not want the Commission to use the Valpak model at all?

IV. STANDARD MAIL PRICING VIOLATES PAEA AND 39 U.S.C. SECTION 101(d).

A. The Disparity in Cost Burden Among Standard Mail Products Is Large and Growing.

The statutory requirement to "apportion the costs of all postal operations to all users of the mail on a fair and equitable basis" (39 U.S.C. § 101(d)) applies to every class of mail — and to products within classes. *See* Section II, *supra*.

Standard Mail, by definition, is mail that is not required to be sent as First-Class Mail or as Periodical class mail. *See* DMM section 243.2.1. Thus, "Standard Mail is typically used for advertisements and flyers." DMM QSG 240b. Since almost all users of Standard Mail are advertisers, one would expect that the coverage of all Standard Mail products would be within a reasonably narrow range, and that the Postal Service could articulate a reasoned basis (*e.g.,* markedly different elasticities) for any significant diversion. Nothing, however, could be further from the truth.

Enormous disparities in coverage exist. Furthermore, generally speaking, the disparities are getting worse, not better. Certain advertisers which use Standard Mail products that the Postal Service can process and deliver efficiently and inexpensively are being forced to pay higher prices so that other advertisers (sometimes their competitors) may choose costly to handle, yet underpriced, products. This is the very definition of unfair and inequitable.

1. Disparities in Coverage.

The FY 2014 ACR sets out the Standard Mail volumes, revenues, and costs for each product in Table 2 (p. 17). As usual, that table does not present the coverage trends for each Standard Mail product, although the Postal Service does provide year-over-year comparisons for the two underwater products, Standard Flats and Parcels. *Id.*, pp. 18-19. Examination of multi-year trends across all Standard Mail products better reveals what has been happening. Table IV-1, *infra*, shows the three-year change (FY 2012 to FY 2014) of the cost coverages of each of the Standard Mail products.

Table IV-1
Standard Mail Products
Cost Coverage (FY 2012-FY 2014)

	FY 2012 Cost Coverage	FY 2013 Cost Coverage	FY 2014 Cost Coverage	Cost Coverage Change FY 2012-FY 2014 (Percentage Points)
HD/Sat Letters	**222.2%**	**235.8%**	**238.0%**	**15.8**
HD/Sat Flats & Parcels	217.3%	229.0%	227.6%	10.3
Carrier Route	130.8%	133.4%	140.2%	9.4
Letters	178.9%	189.0%	200.5%	21.6
Flats	**80.9%**	**84.9%**	**81.6%**	**0.7**
Parcels	85.5%	64.3%	66.3%	-19.2
EDDM-R	N/A	359.9%	379.1%	N/A
Standard Mail	149.0%	159.9%	166.1%	17.1

Two Standard Mail products were deeply underwater in FY 2014 — with Parcels having a 66.3 percent coverage and Standard Flats having a 81.6 percent coverage — whereas other Standard Mail products have extremely high coverages (*e.g.*, 238.0 percent for HD/Saturation Letters). Over the period of the last three years, these disparities have worsened:

- Standard Parcels' coverage has been reduced by 19.2 percentage points;

- Standard Flats' coverage has increased by an insignificant 0.7 percentage points (despite supposedly "above-CPI" increases); and
- HD/Saturation Letters' coverage has increased by 15.8 percentage points.[28]

In Docket No. ACR2013, Valpak's comments complained of the growing intra-class disparity of cost coverage within Standard Mail — particularly the FY 2013 disparity between HD/Saturation Letters and Standard Mail Flats. The **gap** between the coverages of these two products had increased to an astounding **150.9 percent points** (235.8 - 84.9). *See* Docket No. ACR2013, Valpak Reply Comments, pp. 21-23. However, the Commission's ACD never mentioned this issue at all. The Commission, instead, focused on one year improvements in the "unit contribution gap" between Standard Mail Flats and certain **other** Standard Mail products.[29] *See* FY 2013 ACD, p. 54. The gap in coverage between HD/Saturation Letters continues and Standard Flats has increased to an even more astounding **156.4 percentage points** (238.0 - 81.6). Valpak requests the Commission to recognize, and remedy, this large and growing coverage gap in its FY 2014 ACD.

The FY 2013 ACD viewed the one-year 4 percentage point improvement of Standard Flats cost coverage from FY 2012 to FY 2013 as one of the primary reasons to justify no additional remedial action. No such favorable trend can be relied by the Commission in this year's ACD. Indeed, movement (3.3 percentage points) is in the opposite direction. If the

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[28] The highest coverage trend during this three year period was for Standard Letters, increasing 21.6 percent, although that product's coverage still lags far behind HD/Saturation Letters.

[29] Each of the "unit contribution gaps" noted by the Commission to have shrunk in FY 2013 now have increased in FY 2014. *See* Section III.C, *supra*.

existence of a **one year positive** movement dictated the lack of a need for further remedial action last year, then the existence of a **one-year negative** movement should dictate that further remedial action is now needed. *See* Section III.C, *supra*. (Of course the current negative trend is just one of many reasons for the Commission to take further remedial action, as discussed herein.)

2. Disparities in Unit Contribution.

The issue of the "fair" and "equitable" pricing also should be examined from the standpoint of changes in unit contribution. Table IV-2, *infra*, sets out changes in unit contribution over three years for all Standard Mail products.

Table IV-2
Standard Mail Products
Unit Contribution (FY 2012-FY 2014)

	FY 2012 Unit Cont.	FY 2013 Unit Cont.	FY 2014 Unit Cont.	Change	Percentage Change
HD/Sat Letters	**7.5**	8.1	**8.5**	+1.0	**13.2%**
HD/Sat Flats & Parcels	8.9	9.6	10.0	+1.0	11.7%
Carrier Route	5.7	6.2	7.6	+1.8	31.6%
Letters	8.5	9.3	10.3	+1.8	21.4%
Flats	**-9.0**	-6.8	**-9.1**	-0.1	**-1.50%**
Parcels	-17.5	-54.0	-52.5	-35.0	-200.8%
EDDM-R	N/A	10.3	12.3	N/A	N/A
Standard Mail	6.9	7.9	8.7	+1.8	25.8%

The per piece losses of Standard Mail Flats increased from 6.8 cents in FY 2013 to 9.1 cents in FY 2014, wiping out all the gains made in FY 2013. These increased losses occurred despite a 4.3 percent exigent (above CPI) price increase. With unit losses of that magnitude, the Postal Service is extremely fortunate that Standard Flats volume decreased by 9.2 percent since FY 2013.

Furthermore, applying the method of analysis used by the Commission in its FY 2013 ACD (at 54), Table IV-3, *infra*, demonstrates that the **unit contribution gap** between Standard Flats and all of the other profitable products **widened**, not narrowed.

Table IV-3
Standard Mail Products
"Unit Contribution Gap" compared to Standard Flats (FY 2013-FY 2014)

	FY 2013 Unit Cont.	2013 Gap with Flats	FY 2014 Unit Cont.	2014 Gap with Flats	Gap Percentage Change
HD/Sat Letters	8.1	**14.9**	8.5	**17.6**	18.1%
HD/Sat Flats & Parcels	9.6	**16.4**	10.0	19.1	16.5%
Carrier Route	6.2	13.0	7.6	16.7	28.5%
Letters	9.3	16.1	10.3	19.4	20.5%
Flats	-6.8	---	-9.1	---	---
Parcels	-54.0	47.2	-52.5	43.4	-8.1%
EDDM-R	10.3	17.1	12.3	21.4	25.1%
Standard Mail	7.9	14.7	8.7	17.8	21.1%

Every HD/Saturation Letter earns a hefty 8.5 cents, but this contribution is more than offset by 9.1 cents in losses from every Standard Flats.

B. The Coverage of HD/Saturation Letters Has Grown Even Faster than HD/Saturation Flats and Parcels.

Generally, the cost coverage of HD/Saturation Letters has been rising, while the cost coverage of HD/Saturation Flats and Parcels has been declining. In FY 2008, the coverage of HD/Saturation Flats and Parcels exceeded HD/Saturation Letters by 26.4 percentage points. In FY 2014, the relationship was reversed, and HD/Saturation Letters paid a 10.4 percentage point higher coverage. Valpak can recall no discussion by the Postal Service in any docket as to whether this reversal is the result of an intentional Postal Service policy.[30]

Table IV-4
Standard Mail Saturation Products
Cost Coverages

	2008	2009	2010	2011	2012	2013	2014
HD/Sat Letters	230.8%	216.0%	212.8%	221.2%	222.2%	235.8%	238.0%
HD/Sat Flats & Parcels	257.2%	239.6%	224.4%	213.6%	217.3%	229.0%	227.6%

Of course, some of the reason for this reversal in coverage could be attributable to cost changes. For example, unit costs of HD/Saturation Letters moved down, while the unit costs of HD/Saturation Flats and Parcels moved up over the past two years. *See* Table IV-5.

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[30] For example, neither the Postal Service's January 15, 2015 Notice in Docket No. R2015-4 nor the FY 2014 ACR contain any discussion of the relative pricing of HD/Saturation Letters and HD/Saturation Flats and Parcels.

Table IV-5
Standard Mail Saturation Products
FY 2012-FY 2014 Unit Costs

	FY 2012 Unit Costs	FY 2013 Unit Costs	FY 2014 Unit Costs	Change	Percentage Change
HD/Sat Letters	6.24	5.98	6.19	-0.05	-0.8%
HD/Sat Flats & Parcels	7.65	7.43	7.81	+0.16	2.1%

In the pending market dominant price adjustment, the proposed increase for HD/Saturation Letters is above the Standard Mail average, while the proposed increase for HD/Saturation Flats and Parcels is nearly half a percentage point lower. *See* Docket No. R2015-4, Postal Service Notice (Jan. 15, 2015), p. 21. The **cumulative increase** over the last five price increases (not considering the temporary across-the-board exigent surcharge) is **8.6 percent** for HD/Saturation Letters and **7.8 percent** for HD/Saturation Flats and Parcels.

Table IV-6
Standard Mail Products
Percentage CPI Price Increases

	R2011-2	R2012-3	R2013-1	R2013-10	R2015-4
HD/Sat Letters	0.615	2.298	2.059	1.325	2.027
HD/Sat Flats & Parcels	0.403	2.121	2.092	1.124	1.557
SM Overall	1.739	2.041	2.541	1.607	1.866

While the shift of the coverage burden to HD/Saturation Letters may not rise to a violation of 39 U.S.C. § 101(d), to the extent that the Commission issues a remedial order with respect to Standard Mail Flats (as discussed in Section III, *supra*), the Commission should provide that any offsetting price changes first move HD/Saturation Letters coverage downward, at least into parity with HD/Saturation Flats and Parcels.

C. The Valpak Model for Maximizing Contribution Deserves Reconsideration.

It is increasingly obvious that the Postal Service is not applying any known business-like principles in setting Standard Mail prices. Prices do not appear to be based on costs, elasticity, or any other obvious factor. By default, this process has become arbitrary, perhaps politicized, in direct contravention of increased transparency in the price setting process. 39 U.S.C. § 3622(b)(6).

Liquidity, profitability, and contribution are among the most important prerequisites for continued operation of any organization. For reasons discussed herein and in Section I.A, the Commission should reconsider evaluating Postal Service pricing based on the Valpak Contribution Maximizing Model.[31] That model, described separately by Dr. John Haldi as part of Valpak's submission in Docket No. ACR2013, uses linear programming methodology to demonstrate how the Postal Service can obtain greater contribution from price changes **within the confines of the price cap**. Exclusive focus of the model is on Standard Mail. Nevertheless, the maximizing principles set forth there are applicable to each class of mail subject to the price cap. As might be expected, and as discussed below, those principles accord fully with common sense and sound business practice, which should be the whole point of pricing flexibility.

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[31] Docket No. ACR2013, "The Valpak Multi-period Model for Optimizing Contribution from Standard Mail," Valpak Initial Comments, Appendix (Jan. 31, 2014).

The Valpak model assumed, **implicitly** — and the discussion here assumes **explicitly** — that Congress and the PAEA intend for the Postal Service to operate in a financially self-sustaining manner.[32] Accordingly, a primary goal for the Postal Service is that it become and remain financially self-sustaining within the confines of the price cap. The Valpak model is designed to help achieve that goal. In the Executive Summary to the 2013 ACD Financial Analysis (revised April 10, 2014) the Commission opined that:

> the Postal Service's current financial situation **calls into question its long-term viability.** … The Commission concludes that the Postal Service's financial condition **has deteriorated significantly** since the passage of the Postal Accountability and Enhancement Act (PAEA). [*Id.*, p. ii. (emphasis added.)]

The Commission's conclusions and associated dire warning should be taken to heart by the Postal Service — and the Commission which issued it.[33] Figuratively speaking, the warning screams for a laser-like focus on liquidity, profitability, and contribution. To improve the Postal Service's financial condition and assure its viability, the Commission should exercise its

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32 As used here, the term self-**sustaining** is intended to mean that the Postal Service is replacing capital investments and maintaining its physical infrastructure so as to remain up-to-date and fully competitive with others in the delivery business. The term self-**sufficient**, by contrast, is not considered synonymous. It is interpreted here to mean somewhat less — *e.g.*, managing to stay afloat by using up capital stock and living off cash flow from prior investments (*i.e.*, depreciation). When an enterprise is not operated in a self-sustaining manner, then over time the enterprise inevitably will run down — *i.e.*, it gradually will become noncompetitive, and perhaps insolvent (ultimately) or require a bailout, either from ratepayers or taxpayers. To sum up, a large organization such as the Postal Service can operate for many years in a mode that is self-sufficient, but not self-sustaining. Critically, unless the Postal Service is operated in a self-sustaining manner, whether it is compliant with PAEA should be open to serious question.

33 Regrettably, the analysis of financial sustainability in last year's ACD is non-committal with respect to whether Postal Service operations actually were sustainable.

regulatory authority to compel the Postal Service to make assiduous efforts to maximize contribution, at least up to the point where the Postal Service most assuredly is operating in a self-sustaining manner.[34] That, it clearly has not been doing, as acknowledged by the Form 10-K, which states that "[t]he present level of capital expenditures **is not sustainable.**" *Id.*, p. 51.

As discussed below, the Postal Service has a mix of products and services with widely varying cost coverages. The existence of such widely varying cost coverages means that **all revenues are not equal** in terms of whatever contribution they provide. The widely different coverages discussed *supra* testify to the fact that revenues do not provide equal contribution. Unfortunately, this vital distinction seem lost among those Postal Service officials responsible for determining Postal Service pricing policies. Should the Postal Service cease to be a financially viable enterprise, then in retrospect, the obvious questions will be:

- How could the Postal Service get pricing so wrong?
- Didn't the Postal Service realize how much money it was losing?
- Why didn't the Postal Regulatory Commission use its remedial powers?

Some products provide the Postal Service with a contribution sufficiently ample for the organization to be financially self-sustaining, whereas others provide little or even negative contribution.[35] In the former category, large volumes are needed for the Postal Service to

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[34] Even though Valpak has shifted some of its business to electronic media, it continues to have a vital interest in a financially viable postal administration.

[35] The Postal Service reportedly plans to provide itself with extra funds (up to $19 billion) by selling "surplus" real estate. PostCom website, (Jan. 17, 2015), "Page Six." Any such move would provide the Postal Service with a much-needed cash infusion. However, it

become and remain financially self-sustaining. Those products in the latter category either detract from financial self-sustainability, or are marginal to achievement of that goal.

1. Some economic principles for increasing contribution within the confines of the Postal Service's price cap.

Here we seek to explain — without reference to the formal model or any of the equations and mathematical notation which accompanied that presentation — the economic fundamentals for increasing contribution **within a rate cap**.[36] Those principles are simple, straightforward, and quite businesslike.[37] Within each class of mail, the first step is to classify all products and services according to the contribution which they make to the organization's operating profits. Products and services should be grouped according to whether they either:

A. Have negative contribution (*i.e.*, lose money and are underwater); or

B. Make some positive contribution, but not enough to sustain the organization (*i.e.*, coverage more than 100 percent but less than the systemwide average); or

C. Make a contribution which is at a level more than adequate to sustain the organization (*i.e.*, coverage more than the systemwide average).

For any underwater products and services in category A above, a businesslike approach would:

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also would be a one-time event, even if those sales are spread over several years, and would not lay the foundation for operating in a sustainable business model once that one-time infusion is dissipated.

36 The focus here is on contribution, which of course is the difference between revenues and expenses. Oddly, the 2013 ACD Financial Analysis (revised April 10, 2014) discusses in some detail the revenue and expenses of products in each class of mail, but does not compute or discuss contribution of individual products, by far the most critical item.

37 For an analogy, one might consider a company that has entered into bankruptcy and is being financially restructured with the goal of becoming financially self-sustaining,

- Strive to eliminate, as quickly as possible, all losses suffered on account of those products and services failing to cover even their attributable cost.

  - For underwater products, elasticity of demand is not a pertinent consideration (*see* Section IV.C.2, *infra*). Ongoing losses resulting from attributable costs that exceed revenue undermine the organization's financial condition and threaten its long-term viability. Such losses should be viewed as abhorrent, with financial hemorrhaging needing to be stopped as soon a possible. No business which seeks to be self-sustaining knowingly tolerates products with continuing losses for an extended period of time, as the Postal Service has done. By definition, the effect of all such losses is to reduce liquidity, profitability, and contribution.

  - To the maximum extent feasible within the rate cap, large percentage price increases should be imposed on every underwater product or service until each product at least covers its attributable costs. Getting all products just above water is not some kind of financial nirvana, but simply a start down what may be a long and arduous road to truly self-sustaining status.

  - Every price increase can be expected to affect volume (*see* below). With respect to underwater products, the idea is to retain volume that is willing to pay a higher price, while reducing volume that is economically viable only at a below-cost price. If the price of a product is too far below its attributable cost to be corrected because of the shock effect from a single price increase, breaking it down into two or maybe three smaller step increases may be indicated.

  - Possible decline in volume on account of a large price increase does not present an issue with respect to contribution because costs can be expected to decline more than revenue.

  - The only exception to the general principle of not tolerating losses on underwater products might be new products that have low volume and are not yet fully established. Mature products, however, have no grounds for seeking an exception.

  - To sum up, when products lost a substantial amount of money, and those losses could be substantially reduced (or eliminated altogether) by more economic pricing, it is self-evident that the organization could readily increase its contribution.

For marginally profitable products and services in non-sustaining category B:

- Attempt to increase price (along with coverage and contribution) in a manner calculated to do the least harm to the contribution supplied by these marginally profitable products. In general, focus the highest percentage price increases on those products that have the lowest coverage and that provide the organization with the least unit contribution. If some loss of volume must be contemplated because of the necessity for a CPI price increase, contribution is protected more by losing volume with low coverage and retaining volume with higher coverage.

For profitable products and services in category C:

- Restrain all price increases on the most profitable products to the maximum extent feasible, especially those that constitute the lifeblood of the organization "to encourage increased mail volume and operational efficiency." 39 U.S.C. § 3622(c)(7).

2. Considerations of demand elasticity.

All postal products have some elasticity of demand. Consequently, some reduction in demand can be anticipated from every price increase on every product. When a price adjustment is considered necessary, the general approach to protecting liquidity and increasing contribution begins with doing the least harm to contributions being obtained from the most profitable existing products. They are the lifeblood of the organization.

In Docket No. ACR2013, the Commission declined to use the Valpak model because, *inter alia*, the Postal Service did not report elasticities for individual Standard Mail products. Instead, within Standard Mail each elasticity estimate reported by the Postal Service is applicable to multiple products. The Postal Service reports that as yet it has been unable to generate individual product elasticity estimates that it considers to be reliable (despite Commission urgings in the last two ACDs). Although more refined elasticity estimates applicable to individual products would be desirable, they are not a prerequisite for the

Commission to examine inadequacy of Postal Service pricing with respect to contribution.[38] Postal Service pricing cannot be allowed to continue to benefit from its own inability (or unwillingness) to measure elasticities for individual products.

In prior dockets, elasticity estimates have been a source of some contention. In Docket No. R2013-11, the exigent rate case, Postal Service witness Altaf Taufique stated that:

> Standard Mail own-price elasticities are not known with enough certainty to justify mechanistic application in a model whose legitimacy (e.g., vis-à-vis "maximizing" contribution) relies to a great extent on those elasticities. This particularly applies for Standard Mail Flats and Standard Mail Letters whose elasticities are not even estimated separately by the Postal Service. [Response to POIR No. 11, question 8(b).]

Witness Taufique's lack of confidence in the elasticity estimates produced by the Postal Service was echoed in comments filed in that docket by Valassis and NPPC/MMA/NAPM (citing Larry Buc).[39] Elasticity is a vital consideration, regardless of whether one has confidence in the Postal Service's published elasticity estimates. It would be exceedingly foolish to ignore considerations of elasticity altogether.

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[38] Staff members of the Commission made their own independent attempt to devise different ways to measure elasticity in 2014, including elasticity estimates for individual products. *See* Lyudmila Y. Bzhilyanskaya, Margaret M. Cigno, and Edward S. Pearsall, "A Branching Aids Model for Estimating U.S. Postal Price Elasticities," Docket No. RM2014-5, Attachment to Order No. 2117. Results of that exercise generally were supportive of prior Postal Service elasticity estimates, hence added little new information on which the Commission could rely.

[39] Many mailers argue that their demand is more elastic than the Postal Service estimates, and use that as an argument for why price increases on the product(s) they use should be restrained.

Underwater products: elasticity estimates not necessary. With respect to pricing of underwater products, it is not necessary to have elasticity estimates. Nor should their lack be of much consequence until the products are priced above attributable costs. Implications as regards the appropriate price adjustments for underwater products turn out to be similar, regardless of whether elasticity of demand for underwater products is high or low. By way of brief explanation:

- Assume high elasticity. This means that any significant increase in price will cause a substantial reduction in volume — *i.e.*, mailers either cannot or will not pay a higher price that equals or exceeds attributable cost. Under this circumstance, prospects for the underwater product ever becoming profitable are quite low, perhaps virtually nil, and making an "investment" through continued losses and subsidy is not justified.[40] Consequently, there is no excuse for continuing to price the product below cost based on faint hopes that all losses being incurred miraculously will be recouped in the distant future.

- Assume low elasticity. This means that a significant increase in price will result in only a modest reduction in volume — *i.e.*, much of the currently subsidized volume can and will pay a higher price. That in turn means that the Postal Service has no excuse for not terminating the subsidy by immediate price increases, at least to the point where revenues cover costs.

Profitable products: use coverage for guidance. The majority of postal products of course are not underwater — *i.e.*, they are at least marginally profitable — hence the preceding analysis is not applicable to these products. If we accept witness Taufique's premise that Postal Service elasticity estimates are too unreliable to be used for pricing purposes, but acknowledge that elasticity considerations are too important to ignore, the issue becomes: What to do? One approach would be to assume that every profitable product has the same

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[40] The Postal Service would be much better off by investing in new vehicles. Laments about the aging vehicle fleet should be contrasted with the billions of dollars that have been lost on underwater products; *see* Table V-1, *infra*.

demand elasticity — *i.e.*, disregard all differences in elasticity estimates, and assume some moderate level between the high and low estimates generated by the Postal Service.[41]

Fortunately, product revenues, costs, and coverages are far more reliable than the Postal Service's elasticity estimates. No Postal Service witness, not even Altaf Taufique, has cast aspersions on these estimates.[42] Following the general prescription of promoting liquidity by doing the least harm to volume of the most profitable products means that price increases should vary inversely with coverage. For example:

- low coverage products receive a larger (above average) percentage increase.
    - products with the lowest coverage should receive the highest percentage increase.
- high coverage products should receive lower (below average) percentage increases.
    - the most profitable products, those with the highest coverage, should receive lower percentage price increases.

If differences in elasticities were known and utilized, they might alter this general prescription, but the preceding assumes that all elasticities are ignored because of their unreliability.

There is yet another way to account for lack of confidence in the Postal Service's elasticity estimates. Instead of assuming an equal elasticity for all products (as above), to be on the "safe" side temper the Postal Service's estimates in a conservative manner — *e.g.*,

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[41] The Valpak model easily could be adapted to this approach: simply plug in the same estimated elasticity for all products.

[42] The Joint PRC/USPS Periodicals Study determined that the estimates of unit cost were sufficiently reliable to use for pricing purposes.

reduce high elasticity estimates by, say 10 percent, and increase low elasticity estimates by the same amount. Then use the Valpak model with the elasticities so tempered to increase contribution within the rate cap. Use of the Valpak model would be far more systematic, and transparent, than the outcome-driven approach favored by the Postal Service.

V. THE POSTAL SERVICE HAS BEEN UNABLE TO STAUNCH THE HEMORRHAGING CAUSED BY NUMEROUS UNDERWATER PRODUCTS, THREATENING ITS LONG-TERM ABILITY TO MAINTAIN AND CONTINUE DEVELOPMENT OF THE NATION'S POSTAL SERVICES.

A. Postal Service Losses on Underwater Products Again Exceeded $1 Billion.

In FY 2014, remarkably, **for the eighth consecutive year**, the Postal Service **lost over $1 billion** on underwater products.

Postal Service losses on six underwater, market-dominant products totaled **$1.104 billion** in FY 2014. Although there were eight underwater products in FY 2013, and only six underwater products in FY 2014, aggregate losses were virtually the same as the **$1.113 billion** loss sustained in FY 2013.[43] *See* Table V-1, *infra*. Of the six currently underwater products, the largest losses continue to be from Standard Flats and Periodicals Outside County.[44] Losses from these two products alone ($956 million) constitute 87 percent of total losses. Had these losses not been incurred, the **Postal Service's FY 2014 controllable income** would have been **$2.478 billion** (*see* Section I, Table I-2, *supra*).

The problem of Postal Service pricing is more shocking when viewed over the long term. Mailers of underwater market-dominant products have received a subsidy of nearly **$10 billion** — extracted from other mailers — under PAEA. And, the unfairness and inequity violating 39 U.S.C. § 101(d) also extends to subjecting all mailers to: (i) an exigent price increase that could have been postponed (or perhaps avoided altogether); (ii) cutbacks in level

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43 Even the significant exigent price increase implemented in the second quarter of FY 2014 did not cause an improve aggregate losses on underwater products.

44 The entire Periodicals class remains underwater at 76.1 percent cost coverage.

of services; and (iii) reductions in capital investment that is now seeing the Postal Service's fleet of delivery vehicles approach or exceed their service lives (*see* Section V.B, *infra*).

Table V-1
Losses on Market Dominant Products Under PAEA
(Exclusive of Special Services)
FY 2008-2014

Product	FY '08 Deficit (million)	FY '09 Deficit (million)	FY '10 Deficit (million)	FY '11 Deficit (million)	FY '12 Deficit (million)	FY '13 Deficit (million)	FY '14 Deficit (million)	Total (million)
First-Class Parcels	—	—	$1	—	$10	$17	—	$28
Inbound Int. Single-Piece First-Class Mail	$53	$105	$53	$36	$66	$78	$75	$466
Standard Mail Flats	$228	$622	$582	$652	$532	$380	$460	$3,456
Standard Mail Parcels	$167	$208	$178	$117	$53	$39	$34	$796
Periodicals Within County	$5	$15	$25	$20	$29	$22	$19	$135
Periodicals Outside County	$450	$643	$598	$597	$649	$506	$496	$3,939
Single-Piece Parcel Post	$66	$62	$134	$89	$66	$13	N/A	$430
Bound Printed Matter Parcels	—	$9	$28	$5	—	—	—	$42
Media and Library Mail	$60	$75	$90	$99	$56	$58	$20	$458
Total	**$1,029**	**$1,739**	**$1,689**	**$1,615**	**$1,461**	**$1,113**	**$1,104**	**$9,750**

Sources: FY 2008-2014 ACRs.

The Periodicals class has been subsidized both under the Postal Reorganization Act, and PAEA. Mailers in that class are protected by a statutory price cap which applies at the class level, because both Periodicals products are underwater. Since 1997, Periodicals mailers enjoyed their own subsidy of over $6.6 billion. *See* Table V-2. In the FY 2010 ACR, the Postal Service acknowledged that it would be impossible for Periodicals to cover their costs under the price cap and asked the Commission "to determine whether it can exercise any of its powers to remedy the cost coverage shortfall." FY 2010 ACR, p. 7.[45] The Commission soon will have no choice but to reconsider the Postal Service's request in the FY 2010 ACR to determine the precise scope of the Commission's powers with respect to remedying the Periodicals subsidy.

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[45] Moreover, the Commission determined a class-applied price cap trumps the factors and objectives of the Act. *See* FY 2010 ACD, pp. 16-19.

Table V-2
Periodicals Class — Revenues, Costs, Coverages, and Losses
FY 1997 — 2014

	(1)	(2)	(3)	(4)
PRC CRA	Revenue	Costs	Coverage	Loss
Year	($, mill.)	($, mill.)		($, mill.)
Under PAEA				
2014	1,625.3	2,134.2	76.16%	-508.9
2013	1,658.2	2,179.0	76.10%	-520.8
2012	1,731.5	2,401.6	72.10%	-670.1
2011	1,821.1	2,430.0	74.94%	-608.9
2010	1,878.8	2,489.8	75.46%	-611.0
2009	2,038.0	2,680.0	76.04%	-642.0
2008	2,294.9	2,732.1	84.00%	-437.2
2007	2,187.9	2,635.6	83.01%	-447.7
Subtotal	**15,235.7**	**19,682.3**	**77.41%**	**-4,446.6**
Under PRA				
2006	2,124.8	2,487.6	85.42%	-362.8
2005	2,068.9	2,431.6	85.08%	-362.7
2004	2,100.0	2,323.3	90.39%	-223.3
2003	2,139.6	2,196.2	97.42%	-56.6
2002	2,066.9	2,280.4	90.64%	-213.5
2001	2,106.9	2,367.1	89.01%	-260.2
2000	2,076.3	2,354.8	88.17%	-278.5
1999	2,017.7	2,213.1	91.17%	-195.4
1998	1,972.8	2,129.0	92.66%	-156.2
1997	1,964.6	2,038.5	96.37%	-73.9
Subtotal	**20,638.5**	**22,821.6**	**90.43%**	**-2,183.1**
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TOTAL	**34,874.2**	**42,503.9**	**84.40%**	**-6,629.7**

In Docket No. ACR2012, Valpak urged the Commission to find that all the underwater market-dominant products collectively were not in compliance, in part, because those products "are a financial threat to the Postal Service's survival as a financially independent entity…." Valpak Initial Comments, p. 33. The Commission rejected this argument, instead looking at the "differences in the circumstances of products showing a loss." FY 2012 ACD, p. 17. Valpak continues to believe that the cumulative underwater products loss — now approaching $10 billion — deserves a finding of noncompliance by the Commission, and incorporates by reference its discussion in Valpak Initial Comments, Docket No. ACR2012, pages 33-38.

As bad as FY 2014 losses from underwater products were, they were mitigated by extra revenues received due to the temporary exigent surcharge. When those extra revenues end (barring intervention by the D.C. Circuit), losses from underwater products can be expected to increase by more than **$100 million** — based on the analysis in Table V-3. Without those exigent revenues, the coverage of Standard Flats in FY 2014 would have been only **79.5 percent**.[46]

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[46] *See* Docket No. R2013-11, Response of the United States Postal Service to Order No. 2075 (May 15, 2014); Notice of the United States Postal Service of Filing Revenue Collection Report for Quarter 3 of Fiscal Year 2014 (Aug. 15, 2014); and Notice of the United States Postal Service of Filing Revenue Collection Report for Quarter 4 of Fiscal Year 2014 (Nov. 18, 2014).

Table V-3
Subsidized Market Dominant Products (FY 2014)
(Exclusive of Special Services)

Product	**Loss with Exigent Rev. (million)**	**Coverage with Exigent Rev.**	**Loss without Exigent Rev. (million)**	**Coverage without Exigent Rev.**
Inbound Int. Single-Piece First-Class Mail	$75	70.0%	$75[47]	70.0%
Standard Mail Flats	$460	81.6%	$512	79.5%
Standard Mail Parcels	$34	66.3%	$36	64.7%
Periodicals Within County	$19	77.7%	$21	75.6%
Periodicals Outside County	$496	75.8%	$537	73.8%
Media and Library Mail	$20	93.8%	$28	91.5%
Total	**$1,104**		**$1,209**	

Sources: FY 2013 ACR, Tables 1-2, 4-5; FY 2014 ACR, Tables 1-2, 4-5.

B. Liquidity Has Been Unnecessarily Restricted by Losses on Underwater Products.

In its 2014 Report on Form 10-K, the Postal Service notes that:

> Annual capital expenditures have declined from approximately $2.7 billion in 2007 to approximately $781 million in 2014 *to conserve cash*. The present **level of capital expenditures is not sustainable**.… Further, the existing level of cash could be **insufficient to support operations** in the event of another

[47] The Postal Service's reporting of exigent surcharge revenue does not separate inbound international from outbound international. Therefore, this chart does not deduct any of the exigent surcharge revenue from this product.

> significant downturn in the U.S. economy. [2014 Report on Form 10-K, p. 51 (emphasis added).]

In light of this rather candid admission, this year's ACD should give considerable attention to whether the Postal Service in FY 2014 has done anything to improve its liquidity and achieve a sustainable level of operations, including making necessary capital investments.[48]

Since enactment of PAEA in 2006 — even disregarding altogether the issue of retiree health care benefits — Postal Service finances have deteriorated materially. Because the Postal Service opted to lose nearly $10 billion on underwater products, something had to give. One victim of that preference to subsidize underwater products was capital investments, which have been postponed and held to a minimum for several years. The Postal Service fleet of delivery vehicles consequently has suffered. Some vehicles have had to be retired, while the cost of maintaining others has escalated. Although the issue of replacing old vehicles has been much studied, each year the problem has grown a little worse owing to the ongoing liquidity problem, as documented in a recent OIG report.

> The Government Accountability Office (GAO) and the U.S. Postal Service Office of Inspector General (OIG) issued prior reports recommending the Postal Service develop a strategy to address its delivery fleet needs. Management agreed … developed a vehicle replacement plan, and presented it to the Capital Investment Committee on June 23, 2011; however, senior management did not approve the plan because **the Postal Service**

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[48] The Commission's FY 2013 ACD Financial Analysis section contains "Chapter 4. Financial Sustainability Analysis." Although the Postal Service now admits that it was not operating in a sustainable mode in FY 2014, it is of interest that this section of the ACD did not opine on whether the Postal Service was operated in a sustainable mode in FY 2013. It did, however, offer an Altman Z-score analysis which showed "there is a high probability that a [private-sector] business entity with the financial attributes of the Postal Service could fall into bankruptcy." *Id.*, p. 40.

> **lacked the funds to implement it.** Additionally, management … included this [phasing] concept in its short-term vehicle replacement plans submitted for funding in FYs 2012, 2013, and 2014. **The Postal Service's ongoing financial constraints have limited its ability to implement delivery fleet replacement plans.** [USPS OIG, Delivery Vehicle Fleet Replacement (June 10, 2014), Report Number DR-MA-14-005, p. 1.]
>
> The Postal Service … long-term plan included purchasing the next generation of delivery vehicles beginning in FY 2017. … **Despite 3 years of effort, the Postal Service has not** approved or **fully funded either plan**…. **The Postal Service has not** fully developed or **funded these plans due to financial constraints**…. aging vehicles are typically repaired when they break down even though it would sometimes be more cost effective to replace them. [*Id.*, p. 2.]
>
> The Postal Service … long-term plan included purchasing the next generation of delivery vehicles beginning in FY 2017…. **Despite 3 years of effort, the Postal Service has not** approved or **fully funded either plan**…. **The Postal Service has not** fully developed or **funded these plans due to financial constraints**…. aging vehicles are typically repaired when they break down even though it would sometimes be more cost effective to replace them. [*Id.*, p. 2.]
>
> The Postal Service developed a long-term plan to purchase the next generation of collection and delivery vehicles beginning in FY 2017; however, the plan has not been formalized. According to Postal Service officials, this acquisition will be a lengthy process…. the entire process from vehicle design to complete replacement of LLVs [long-life vehicles] could take more than 10 years and **cost more than $5 billion.** They stated that, from 2003 through 2005, they developed a detailed acquisition strategy **that was never funded.** They do not think it is worthwhile to repeat the process now, **particularly in view of the uncertainty of funding due to the Postal Service's continued financial losses.** [*Id.*, p. 4.]

On the basis of this OIG Report, it would appear that those responsible for the Postal Service's fleet have been concerned about the constraint on investment imposed by the lack of liquidity. At the same time, those responsible for pricing seem either to be insulated from or oblivious to such concerns. In addition to having 140,000 delivery vehicles that are at least 20 years old and nearing the end of their useful life, the recent 2014 Report on Form 10-K says that the Postal Service also has other investment needs that are substantial and growing:

> Some facilities maintenance has been deferred in recent years to save cash and the backlog needs to be addressed. Investments in package sorting and handling equipment are needed to fully capitalize on business opportunities in the growing package delivery market and other letter sorting equipment must be updated.... The Postal Service has conserved capital in recent years by spending only what it believed essential to maintain its existing facilities and service levels.[49] However, an increase of capital investment is necessary to upgrade its facilities, existing fleet of vehicles and processing equipment in order to remain operationally competitive. [2014 Report on Form 10-K, pp. 51-52.]

The Postal Service does not indicate the full extent of investment needed to replace its entire vehicle fleet and restore the infrastructure. Clearly, however, just replacing those 140,000 vehicles that are at least 20 years old will require a considerable sum of money. The OIG Report indicates that replacement of the long-life delivery vehicles alone could cost $5 billion. And sooner or later still more money will be needed to replace the other 70,000 or so vehicles in the Postal Service inventory. FY 2014 Comprehensive Statement of Postal Operations, p. 55. One important reason that the Postal Service does not now have funds

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[49] It is not altogether clear what the Postal Service did with the capital that it allegedly "conserved" in recent years. However, it is clear that prior to 2014 the Postal Service had not hoarded cash and increased its liquidity. As a matter of fact, at the beginning of 2014, cash was at a rather low level for an organization the size of the Postal Service. Instead of accumulating cash, the Postal Service opted to underwrite losses on underwater products, postpone personnel reductions to accord with attrition almost solely through retirement, and delay making various other cost reductions.

available is that it deliberately failed to cut losses on underwater products and generate more liquidity when it had the opportunity to do so.

C. Migration of First-Class Mail Combined with Losses on Underwater Products Is Crippling Postal Service Finances.

Concerns about financial sustainability were raised by the GAO at least two years ago. In testimony before the Senate Committee on Homeland Security and Government Affairs, Comptroller General of the United States Gene Dodaro stated:[50] "USPS lacks liquidity to maintain its financial solvency or finance needed capital investment." *Id.*, p. 2.

A major impediment to achieving a self-sustaining operation will be the ongoing migration of hard-copy mail to electronic alternatives. *See* 2014 Report on Form 10-K, p. 51. Among the profits most at risk from such migration are those of First-Class Mail, which is by far the Postal Service's most profitable class of mail. Table V-4 projects continued annual migration of First-Class Mail over the next five years at somewhere between 3 and 4 percent,[51] and assumes that, as the volume of First-Class Mail declines, the Postal Service is able to anticipate and adjust its attributable costs **in tandem, with no lag**. Any material lag in reducing attributable costs would worsen the deficit caused by migration to electronic media.

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[50] *See* "Urgent Action Needed to Achieve Financial Sustainability," Statement of Gene L. Dodaro, Comptroller General of the United States (Feb. 13, 2013) GAO-13-347T, p. 2.

[51] RPW Reports indicate that the annual volume of First-Class Mail declined by 4.2 and 3.3 percent in, respectively, FY 2013 and FY 2014. In light of this most recent experience, the 3 and 4 percent rates of decline assumed here thus appear to encompass a reasonable range. With respect to mail in other classes, no volume changes are assumed.

Table V-4

Projected Diminution of First-Class Revenues and Contribution (millions, 2014 constant dollars)

	Diminution @ 3%		Diminution @ 4%	
	Revenue	Contribution	Revenue	Contribution
2015	882	484	1,176	645
2016	1,738	953	2,306	1,264
2017	2,568	1,408	3,390	1,859
2018	3,373	1,850	4,430	2,430
2019	5,154	2,278	5,430	2,978

Looking out five years, to FY 2019, a $2.3 to $3.0 billion diminution in contribution resulting from continued migration of First-Class Mail to electronic communications and transactional alternatives is foreseeable **even if the exigent surcharge does not expire**.[52] Also, unit revenues and unit costs of most products can be expected to increase, roughly in line with the CPI. The collective effect of all such other changes on contribution is viewed as relatively minor in the context of a multibillion dollar contribution shortfall occasioned by (i) a continued decline in the volume of First-Class Mail, and (ii) a backlog of investment needs requiring many billions of dollars.

The preceding exercise serves to illustrate how vulnerable the Postal Service is to the potential loss of its profitable First-Class Mail volume.[53] If such loss somehow were to be

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[52] This projection should not be viewed as any type of forecast. For example, no effort is made to project or anticipate changes that may occur in other classes of mail, even though many changes inevitably will occur during the ensuing five years. Some possible changes have positive implications, *e.g.*, declines in the volume of underwater Periodicals and Standard Flats may continue, and that would improve liquidity.

[53] The discussion here is limited to First-Class Mail. The basic thought, however, also applies equally to Standard Mail. Continued subsidization of underwater products,

combined with a surge in the volume of underwater products (*e.g.*, Standard Flats and Periodicals), the Postal Service would find itself in deep financial trouble rather quickly. Recent trends in the volume of these major underwater products have been declining, despite efforts of the Postal Service to keep their prices below cost and maintain their volume (while continuing to lose money). From the perspective of Postal Service finances, it therefore is indeed fortunate that no such volume surge appears to be in the offing, thus preventing losses on money-losing products from ballooning up.

How should the projections in Tables V-4 be viewed? They are a straightforward yet simplified exercise in establishing reasonable parameters to use in planning for contingencies deemed feasible. No quantitative assessment of likelihood is required.[54] The strong indication from this exercise is that in order to make needed investments in vehicles and infrastructure and help restore liquidity to a level which the Postal Service deems more adequate, contribution must grow substantially in excess of whatever shortfall happens to materialize on account of continuing migration from First-Class Mail. This means that far more strenuous cost reduction efforts will be required in order for the Postal Service to become financially

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supported by overpricing of the most profitable Standard Mail products, is likely to promote migration of those profitable products and should be viewed as a threat. Electronic advertising and solicitation are said to be increasingly cost-effective; *see* Docket Nos. R2015-2 and MC2015-3, statement of Harit Talwar, Chief Marketing Officer of Discover Financial Services.

[54] Within this contingency planning exercise, speculation about any legislative change will not be engaged in here. The focus is solely on **operational changes within the Postal Service's existing statutory authority,** *e.g.*, the announced consolidation of up to 82 mail processing facilities beginning in 2015. 2014 Report on Form 10-K, p. 51.

self-sustaining through its own initiative. In other words, the Postal Service needs to do far more than just "tread water" financially, which is more or less what it did in FY 2014.

To live within its means and help restore liquidity, Postal Service management clearly needs to think (and act) in terms of taking all actions within its control to improve its bottom line **by billions of dollars.** In prior years the Postal Service really could not afford to continue incurring annual billion dollar losses on underwater products, but it nevertheless opted to do so. If investment needs indeed are approaching a critical state as claimed, the Postal Service most assuredly cannot continue postponing vehicle replacement and other such responsibilities, because when its aging vehicles reach the point where they are no longer operable the Postal Service will not be able to fulfill its Universal Service Obligation.

The statute authorizes the Postal Service to make many difficult decisions that would help improve contribution and liquidity, perhaps dramatically. A major purpose of the price cap was to force those decisions on Postal Service management. Other than pricing, which the Commission is supposed to regulate, management has wide latitude to set its own priorities. So long as management postponed making and implementing those decisions, and failed to initiate cost-reducing actions not precluded by the statute or union contracts, that was a clear indication that senior management had (and still may have) other priorities. Internal Postal Service concerns about investment needs, such as those documented in the OIG Report cited previously, should be directed not to Congress or the general public, but to those at the Postal Service responsible for pricing Standard Flats and other money-losing products. And the Commission cannot wait until the Postal Service is further financially crippled before it acts to prevent the further deliberate underpricing of postal products, lest it become an accessory to fiscal irresponsibility.

VI. MARKET-DOMINANT NEGOTIATED SERVICE AGREEMENTS WERE NOT COMPLIANT WITH PAEA DURING FY 2014.

The FY 2014 ACR reports that there were three domestic market-dominant negotiated service agreements in effect during FY 2014. In addition to the statutory criteria governing all postal prices, NSAs are considered "special classifications" which must comply with other specific requirements set out in 39 U.S.C. § 3622(c)(10):

> **the desirability of special classifications** for both postal users and the Postal Service in accordance with the policies of this title, including agreements between the Postal Service and postal users, when available on public and reasonable terms to similarly situated mailers, that —
> (A) **either** —
> (i) improve the net financial position of the Postal Service through reducing Postal Service costs or increasing the overall contribution to the institutional costs of the Postal Service; or
> (ii) enhance the performance of mail preparation, processing, transportation, or other functions; and
> (B) do not cause unreasonable harm to the marketplace.
> [Emphasis added.]

A. Discover Financial Services NSA

The ACR explains that the Discover Financial Services ("Discover") NSA was the only NSA which had a full contract year that ended in FY 2014, and for which the Postal Service paid rebates. The Postal Service makes no claim that the Discover NSA — or any of the NSAs — was justified under PAEA as "reducing Postal Service costs" or "enhanc[ing] the performance of" postal functions. Thus, the Postal Service must demonstrate that these NSAs "improve the net financial position of the Postal Service…." The ACR reports that the Discover NSA resulted in a **net increase** in contribution to the Postal Service **of between $18.2 million and $23.1 million**. The Postal Service asserts: "**It is clear**, then, that the

Discover NSA improved the net financial position of the Postal Service…." and "[t]hus, the Discover NSA … satisf[ies] section 3622(c)(10)(A) and the Commission's rules." FY 2014 ACR, p. 38 (emphasis added). Of course, the Postal Service's representations of legal compliance are based on the Postal Service's own invented, unapproved methodology.

The Postal Service's reporting gimmick is growing old, having been repeated again and again, defying the authority of the Commission to approve costing methodologies, and to prescribe required reporting by the Postal Service.

The Postal Service presents the "net value to USPS" using Commission's methodology only as an afterthought. However, using the Commission's methodology, the Postal Service's workpapers reveal "clearly" that the Postal Service lost money on the Discover NSA. Using the only legitimate methodology — the Commission methodology — reveals a **net reduction in contribution** (**loss**) to the Postal Service of **$14,151,180**. Instead of "satisfy[ing] section 3622(c)(10)(A)," the Discover NSA violated that statutory requirement.

Refreshingly, Chairman's Information Request No. 2, question 19 (Jan. 16, 2015) required the Postal Service to "correct the FY 2014 ACR to reflect the approved methodology [and] include a revised discussion explaining whether the Discover NSA satisfies section 3622(c)(10)(A) and the Commission's rules." The Postal Service filed a revised page 38 of the ACR in response to ChIR No. 2, question 18, but insists that it "views its preferred net value estimation methodology as better suited than the Commission's for analysis of commercial corporate mailing activity." FY 2014 ACR, p. 38 n.15a (revised Jan. 23, 2015).

Even in prior dockets when the Commission tolerated erroneous Postal Service reporting, it has been clear that NSAs have not been compliant with PAEA. Nonetheless, the

Commission has averted its eyes to mounting losses and the requirements of section 3622(c)(10).[55] For example, in the FY 2012 ACD, the Commission found that the Discover NSA resulted in a **net loss of $4.3 million**, but the Commission merely requested the Postal Service to think some more about how it is violating 39 U.S.C. § 3622(c)(10) and whether it would really like to continue losing money:

> *If the Postal Service is not realizing a net benefit due to the agreement or the insights gained by its implementation by that time, the Commission recommends that the Postal Service re-evaluate the benefits and costs of continuing the NSA.* [FY 2012 ACD, p. 158.]

Again, in the FY 2013 ACD, four days before the end of the third and final year of the Discover NSA, the Commission found that year two had also (and predictably) resulted in a **net loss of $6.9 million** to the Postal Service. FY 2013 ACD, p. 62. But again, the Commission avoided taking action:

> *As implemented by the Postal Service, the NSA is inconsistent with section 3622(c)(10).... The Commission directs the Postal Service to provide in its FY 2014 ACR, a detailed analysis of the lessons learned from the DFS NSA. Specifically, the Postal Service shall address: (1) how well the NSA achieved its goal of maintaining DFS's total contribution from First-Class Mail and Standard Mail; (2) how well the NSA achieved its goal of providing an incentive for growth in net contribution beyond that; (3) the lessons the Postal Service has learned regarding methods for staunching First-Class Mail volume declines; and (4) what efforts the Postal Service has made to develop a net value method with quantitative inputs.* [FY 2013 ACD, pp. 68-69.]

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[55] When the Commission approved the Discover NSA, it knew that "analysis indicates that the agreement is unlikely to increase the net contribution to the Postal Service" — the only statutory basis on which it could be approved. Approval was predicated on the non-statutorily permissible grounds that "allowing this negotiated service agreement to proceed will allow management to enhance its knowledge of potential tools to slow the overall declining trend for First-Class Mail volume." Commission's Order No. 694 (Mar. 15, 2011), pp. 14-15.

The Postal Service's repeated claims of "clear" compliance with section 3622(c)(10) based on its own methodology are patently false. If anything is "clear," it is that the clear language of the statute — that an NSA "improve the net financial position of the Postal Service" — is being disregarded and disrespected by a government monopoly that has been allowed to disperse millions to favored mailers without supervision. Because the Discover NSA has now ended, the only task left for the Commission is to make an express finding of statutory violation and "remedy the effects of any noncompliance." 39 U.S.C. § 3662(c). The Commission should ask the Postal Service to explain how it proposes to "remedy" its losses to Discover. At a minimum, since Discover received millions of dollars to which it should never have been entitled under PAEA, the Commission should reject the pending Discover NSA (Docket Nos. MC2015-3 and R2015-2). Alternatively, approval of the new Discover NSA could only be approved if it results in net additional contribution over and above the lost contribution from the recently ended Discover NSA — $25,350,000.

B. PHI Acquisitions NSA

Although the PHI NSA was not in effect for a full year in FY 2014, as it was implemented during FY 2014, Q4, the Postal Service presents some data about the FY 2014 financial results. The Postal Service claims that "net benefit of the [PHI] NSA cannot yet be evaluated on a contract-year basis, as the agreement has not been in effect for a full year." FY 2014 ACR, p. 38.

Nevertheless, the USPS-FY14-30 shows the net result using the Commission-approved methodology, which is a **reduction in contribution** to the Postal Service of **$128,090**. That is, the **rebates of $174,778** that were paid to PHI exceeded the contribution from the additional volume incented by the rebates. *See also* Postal Service Response to ChIR No. 2, Q. 4.

Given the Postal Service's track record on the profitability of NSAs (as well as the accuracy of the subjective volume projections — *see* Docket No. MC2015-3, Comments of the Public Representative, Appendix A), the Commission should take a more proactive approach to monitoring the status of approved NSAs, and should consider in this docket and each succeeding ACR whether the PHI NSA — a five-year agreement — is profitable, lawful, and should be allowed to remain in effect.

C. Conclusion

The Postal Service's domestic market dominant NSA program has proven to be a failure. Taken together, the NSAs in effect since PAEA was enacted have lost nearly $50 million. *See* Table V-1. The Discover NSA has now lost over $25 million, eclipsing the $23 million loss from the Bank of America NSA — a loss so large that even the Postal Service decided to cancel the NSA.

Table V-1
Summary of Market Dominant NSAs
Net Effect on Postal Service Contribution
($ Thousands)

	2009	2010	2011	2012	2013	2014	Total
Bookspan							20
Lifeline	25	104	0				129
Bradford Group	93	(72)	(37)				(16)
Bank of America	(23,514)						(23,514)
Discover				(4,338)	(6,861)	(14,151)	(25,350)
Valassis							
PHI Acquisitions						(128)	(128)
Total	**(23,396)**	**32**	**(37)**	**(4,338)**	**(6,861)**	**(14,279)**	**(48,859)**

The Commission should make a finding that the domestic market dominant NSAs in FY 2014 were not in compliance with Title 39, individually, or collectively, or both individually and collectively. Such NSAs require the Commission to determine an appropriate remedy. 39 U.S.C. § 3662(c). Furthermore, the Commission should recognize the financial damage that ultra "light-handed" regulation over NSAs has done to the Postal Service. And, the Commission should resolve to apply the preconditions of the statute as written in all cases, including rejecting the currently pending Discover NSA in Docket Nos. MC2015-3 and R2015-2.

VII. THE COMMISSION MUST ISSUE AN ORDER MANDATING AN "ADEQUATE REMEDY" FOR THE PROBLEM OF STANDARD FLATS AND STANDARD MAIL PRICING.

In its FY 2010 ACD, when the Commission first found noncompliance in Standard Flats, the Commission identified several factors "which, together, constituted circumstances that triggered section 101(d)'s failsafe protections." Order No. 1427, p. 9. On remand from the D.C. Circuit, the Commission left itself plenty of regulatory flexibility, explaining that no specific set of factors necessarily supports a finding of noncompliance: "variants of those factors could also trigger the protections of section 101(d). Moreover, other factors not present in the FY 2010 ACR, could emerge to support a conclusion that an extreme case requiring action under section 101(d) existed." *Id.* The Commission concluded that "while circumstances justifying invocation of section 101(d) may vary, in making any such determination, the Commission considers the totality of the circumstances presented.... The[] identification [of the relevant factors in FY 2010 ACD] does not, however, preclude the conclusion that other combinations of those, or other, relevant factors may authorize action under section 101(d)." *Id.*, p. 10.

Looking at the totality of circumstances in FY 2014 discussed *supra*, the Commission should find that:

(i) Standard Mail Flats remained out of compliance in FY 2014, and

(ii) prior remedial directives have failed to resolve that noncompliance.

Once the Commission found Standard Flats pricing to be in violation of PAEA in Docket No. ACR2010, and when it again finds that violation in this docket, it becomes "**obligated**" by section 3662(c) to provide what the D.C. Circuit describes as an "**adequate**

remedy," one that redresses the wrong both by bringing the Postal Service into compliance with the law and by remedying any effects of prior noncompliance. *See* Gamefly, Inc. v. Postal Regulatory Commission, 704 F.3d 145, 149 (D.C. Cir. 2013) (emphasis added). In Gamefly, the Commission "issued an order finding that the Postal Service was indeed discriminating against Gamefly," in violation of 39 U.S.C. § 403(c), which, in pertinent part, requires the Postal Service to "provid[e] services and … establish[] classifications, rates, and fees" that do not "make any undue or unreasonable discrimination among users of the mails." *Id.* at 148. But the D.C. Circuit ruled that **the Commission's "remedy left much of the discrimination in place**." *Id.* at 146 (emphasis added). Indeed, the remedial order issued by the Commission in the Gamefly complaint docket, Docket No. C2009-1, was inadequate as it "could still require GameFly to 'continue to generate more than double the contribution per piece than Netflix mail.'" *Id.* at 148. The D.C. Circuit ruled that the Commission's order was "arbitrary and capricious because it **left discrimination in place** without reasonable explanation." *Id.* at 149 (emphasis added). Vacating the Commission's order, the court remanded the case "for an **adequate remedy**," instructing the Commission that it "**must** either remedy all discrimination or explain why any residual discrimination is due or reasonable under §403." *Id.* at 149 (emphasis added).

As in Gamefly, the FY 2010 ACD directive to the Postal Service relating to Standard Flats has proven over many years woefully inadequate to resolve the violation found. And the unfairness and inequity of requiring other mailers to cross-subsidize Standard Flats has continued for multiple years, and with no end in sight, as the Postal Service admits.

Section 101(d) requires fairness and equity in the apportionment of "the costs of all postal operations to all users of the mail." The pricing of the various Standard Mail products reflects the apportionment of costs. Based on analysis of coverages, or of unit contribution, Standard Flats cannot be said to be "on a fair and equitable basis" when compared to other Standard Mail products — especially HD/Saturation Letters.[56] As the D.C. Circuit said in upholding the Commission's finding in the FY 2010 ACD, "the persistent losses incurred by Standard Flats amount[s] to **a subsidy of Flats at the expense of other Standard Mail products (and their customers)**...." U.S. Postal Service v. PRC at 1106 (emphasis added). In its FY 2014 ACR, the Postal Service never even attempted to demonstrate that Standard Flats pricing complied with section 101(d) or any other provision, despite the Commission's remedial order. Instead, it merely asserted that "it agrees with the Commission that having products cover their costs is an appropriate long-term goal." FY 2014 ACR, p. 19 (footnote omitted). Having wholly failed to justify its unfair and inequitable allocation of costs among Standard Mail Products, the pricing of Standard Flats should be deemed unfairly and inequitably low, and the pricing of other Standard Mail products, especially HD/Saturation Letters, be deemed unfairly and inequitably too high, in violation of section 101(d).

Price cap regulation, as devised by Congress and implemented by the Commission, gives the Postal Service considerable flexibility. Yet the Postal Service has abused that flexibility by allowing unnecessary losses and expenses to undermine profitability and erode its

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[56] Although the Postal Service is permitted to make "changes of unequal magnitude within, between, or among classes of mail" (39 U.S.C. § 3622(b)(8), that power does not override the need to comply with the "fair and equitable" requirement of section 101(d).

liquidity while living on capital. To return to a self-sustaining status, the Postal Service must do a far better job of increasing liquidity, profitability and contribution **within the price cap space**. Otherwise, the Postal Service will require a bailout, with price cap regulation of the Postal Service coming to naught.

A price cap imposes a give-and-take situation. Once a price adjustment for a product within a class of mail reaches the cap, a further increase in the price of any one product requires an off-setting decrease in the price of one or more other products. Accordingly, restraining price increases on underwater products not only fails to eliminate losses, but also forces price increases on more profitable products within the class. Such pricing is diametrically opposed to the Postal Service's own self interest, and also is totally unbusinesslike, a gross misuse of pricing flexibility. The Commission has tolerated its scheme for price cap regulation to be undermined while acknowledging that, without the ability to generate sufficient cash from business operations, the Postal Service cannot continue to operate. Should a shortage of cash brought on by poor pricing decisions cause the Postal Service to cease operating and go into reorganization, all else becomes academic.

The Postal Service has not always been so obstinate about Standard Flats pricing. There was a time that the Postal Service expressed a willingness and perhaps a desire to have Standard Flats pay its way — but that was before the Commission issued its remedial order in the FY 2010 ACD. In the Postal Service's first proposed exigent price adjustment (Docket No. R2010-4, which was rejected by the Commission), the Postal Service proposed achieving 100 percent cost coverage for Standard Flats in five years, as follows:

- one **5.1 percent** exigent increase in 2010, followed by

- five annual increases that were **2 percent above CPI**. [*See* Commission discussion of this proposal in FY 2010 ACD, p. 104.]

However, following the Commission's rejection of the exigent increase, the Postal Service refused to follow through even with its 2 percent above-CPI price increases for Standard Flats, claiming that the plan is "no longer workable." *Id.*, p. 105. With the passage of years, and continued losses, a much more aggressive remedy is now necessary. It is the Commission's responsibility to order substantial increases in the price of Standard Flats offset by significant redactions in HD/Saturation Letter prices, as well as other high-coverage Standard Mail products.

Respectfully submitted,

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APPENDIX

POSTAL SERVICE COMPLIANCE WITH FY 2010 ACD STANDARD FLATS REMEDIAL ORDER

The Initial Comments, *supra*, demonstrate why the Commission's remedial order regarding deeply underwater Standard Flats in the FY 2010 ACD must be strengthened to effect significant changes in Standard Mail pricing. To provide a context to the Commission's consideration of the type of order that is now necessary, a review of the Postal Service's responses to the earlier Commission remedial order is instructive. The Postal Service responses could be summarized as alternatively challenging, defying, ignoring, and minimally complying with the Commission remedial order, as detailed below.

A. Docket No. ACR2010

In its FY 2010 ACD, the Commission found that the Postal Service's pricing of Standard Flats violated 39 U.S.C. § 101(d). FY 2010 ACD (Mar. 20, 2011), p. 106. It determined that the compelled cross-subsidization of Standard Flats by other products "reflects an unfair and inequitable apportionment of the costs of postal operations to all Standard Mail users…. [and that t]he Postal Service has failed to utilize the pricing flexibility granted to it by the PAEA to address this issue…." *Id.* Thus, the Commission ruled that other Standard Mail users, including Valpak, were charged too much, while Standard Flats users were charged too little.

Based on its finding of a statutory violation, the Commission then directed the Postal Service to take four remedial actions:

> Pursuant to section 3653(c), the Commission **directs** the Postal Service to **increase the cost coverage of the Standard Mail Flats product** through a

> combination of **above-average price adjustments**, consistent with the price cap requirements, and **cost reductions** until **such** time that the **revenues** for this product exceed attributable costs.
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> * * *
>
> Within 90 days of the issuance of the FY 2010 ACD, the Postal Service shall present a **schedule** of future **above-CPI price increases** for Standard Mail Flats….
>
> * * *
>
> In subsequent ACRs, the Postal Service shall **report** the following information:
>
> - describe all **operational changes** designed to reduce flat costs in the previous fiscal year and estimate the financial effects of such changes;
> - describe all **costing** methodology or measurement improvements made in the previous fiscal year and estimate the financial effects of such changes;
> - a **statement** summarizing the historical and current fiscal year subsidy of the Flats product; and, the estimated **timeline** for phasing out this subsidy.
>
> In subsequent Notices of Market Dominant Price Adjustments, the Postal Service shall report the following information:
>
> - an explanation of how the proposed prices will move the Flats cost coverage toward 100 percent, and
> - a statement estimating the effect that the proposed prices will have in reducing the subsidy of the Flats product. [FY 2010 ACD, pp. 106-07 (emphasis added).]

The Postal Service appealed the Commission's finding and order, filing a Petition for Review. On April 17, 2012, the U.S. Court of Appeals for the D.C. Circuit upheld the Commission's finding and remedial order, only remanding to the Commission for "definition of the circumstances that trigger § 101(d)'s failsafe protection, and for an explanation of why the particular remedy imposed here is appropriate to ameliorate that extremity." U.S. Postal Service v. Postal Regulatory Commission, 676 F.3 1105 (D.C. Cir. 2012). On remand, the Commission affirmed its remedial order and provided the explanation required by the court.

See Order No. 1427. Following that, in Order No. 1472, the Commission confirmed the termination of a partial stay,[57] and ordered the Postal Service to provide the information required by the FY 2010 ACD as well as to provide the schedule of above-CPI price increases with its FY 2012 ACR.

B. Docket No. R2012-3

In its Notice of Market Dominant Price Adjustment in Docket No. R2012-3 (Oct. 18, 2011), the Postal Service purported to comply with the FY 2010 ACD by giving Standard Flats an above-CPI price increase, but offered only minimal technical compliance: the increase for Flats was **0.076** percentage points above the price cap (*i.e.*, CPI x 1.035). The Commission allowed this minimal compliance in part because of the pendency of the appeal of the FY 2010 ACD and in part because the "Postal Service technically complied with the Commission's directive." Order No. 987, p. 32.

Additionally, the Postal Service failed to file the information that the Commission required in its FY 2010 ACD order applicable to subsequent notices of market dominant price adjustments. Valpak pointed this out in its comments (Valpak Comments, pp. 12-13 (Nov. 7, 2011)), but the Commission largely ignored the failure, merely stating that it was "concerned with the lack of explanation provided by the Postal Service as directed in the FY 2010 ACD." Order No. 987, p. 32. The Commission also stated that it "expects the Postal Service to file an explanation of how price increases and cost reductions are being used to reduce the intra-

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[57] During the pendency of the appeal, the Commission had stayed a portion of its order: the requirement that the Postal Service provide a schedule of above-CPI price increases. *See* Order No. 739.

class cross-subsidy and to improve the cost coverage for Standard Flats in the next Annual Compliance Report." *Id.*, p. 4.

C. Docket No. ACR2011

The Postal Service deliberately disregarded the Commission's FY 2010 ACD remedial order by not filing any of the required information with its FY 2011 ACR. ChIR No. 1, Q. 9 (Jan. 19, 2012) requested the information that the Postal Service should have filed with both the FY 2011 ACR and the Docket No. R2012-3 Notice of Market Dominant Price Adjustment.

In the FY 2011 ACD, the Commission once again found Standard Flats to be out of compliance, but did not order additional remedial action because the appeal of the FY 2010 ACD was still pending. *See* FY 2011 ACD, p. 119.

D. Docket No. R2013-1

In the next pricing adjustment, once again the Postal Service deliberately disregarded the Commission's remedial order, requiring the Commission to request the required information. *See* CIR No. 1, Q. 1. The Postal Service's Notice also deliberately disregarded the remedial order requirement to provide **above-cap** price adjustments for Standard Flats, instead purporting to give an **at-cap** price adjustment. Certain recalculations revealed that the Postal Service's proposed increase for Standard Flats was actually **below the cap**, and the Commission rejected and remanded the prices. On remand, the Postal Service provided a tiny increase to Standard Flats amounting to CPI x 1.018. Nevertheless, the Commission approved the prices on remand, stating, "Although Valpak and the Public Representative take issue with the amount of the price increase, the Commission concludes that these rates comply with the FY 2010 ACD directives." Order No. 1573, p. 5. The only sense in which they could have been said to comply was that they were technically, barely, above average, demonstrating that the Postal Service had no realistic goal of ever having Standard Mail Flats priced so as to cover its costs.

E. Docket No. ACR2012

In the FY 2012 ACR, the Postal Service again deliberately disregarded the FY 2010 ACD remedial order. The Commission routinely issued ChIR No. 1, Q. 2 (Jan. 4, 2013). Further questions about Standard Flats were asked by the Commission on Valpak's motion. ChIR No. 4, Q. 1-4. In that request, the Commission noted only that "In its FY 2012 ACR filing, the Postal Service was not responsive to the Commission's FY 2010 ACD directive." FY 2012 ACD, p. 111.

In its determination, the Commission looked at the totality of circumstances presented in FY 2012 — as it described in its Order on Remand, Order No. 1427 — and determined that:

> the steps taken thus far [by the Postal Service] have been helpful but it is **concerned** that the Postal Service has not quantified the cost savings from operational changes designed to reduce Flats costs. Consequently, the Commission **cannot properly assess**[58] the likely rate of improvement in the cost coverage shortfall. [FY 2012 ACD, p. 116 (emphasis added).]

The Commission observed that, because "the Postal Service has **begun to make progress** towards addressing the issues raised by the Commission in the FY 2010 ACD," no changes were required "to the Commission's FY 2010 ACD directive." *Id.* (emphasis added).

Unlike the FY 2010 ACD and the FY 2011 ACD, the Commission did not appear to make an express finding of noncompliance in the FY 2012 ACD. However, given the fact that

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[58] Of course, there is no way for the Commission to confirm or analyze "anticipated cost savings" because the Postal Service never provides any information.

it maintained the remedial directives of the FY 2010 ACD, the Commission's comments were consistent with an implicit finding that Standard Mail Flats once again were not in compliance during FY 2012, or at least that the FY 2010 ACD finding and order were still in effect.

F. Docket Nos. R2013-10 and R2013-11

Maintaining its deliberate defiance of the Commission's authority, the Postal Service did not submit the information required by the Commission's remedial order in FY 2010 ACD in either Docket No. R2013-10 (annual CPI adjustment) or Docket No. R2013-11 (exigent price adjustment). In both cases, the Commission had to issue information requests in order to have the Postal Service submit the required information. *See* Docket No. R2013-10, Postal Service response to ChIR No. 3, Q. 6; Docket No. R2013-11, Postal Service response to POIR No. 2, Q. 9.

In both cases, the Postal Service represented that "anticipated cost savings" would increase Standard Mail Flats cost coverage to 87 percent for FY 2013. Of course, now we know that this "estimate" was in error — fully 2 percentage points higher than the actual coverage.[59] It was on the basis of that erroneous estimate that the Commission approved Postal Service pricing.

The price increase in Docket No. R2013-10 for Flats was slightly above the cap, and even above CPI x 1.05, at CPI x 1.067. However, in Docket No. R2013-11, the Postal Service deemed an across-the-board approach to be a fair dispersal of the burden of the liquidity crisis (such crisis having been caused in no small part by continued high tolerance for

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[59] It is hoped that perhaps the Commission will bear this point in mind the next time the Postal Service claims unsupported cost savings.

losses of underwater products on the part of the Postal Service and the Commission). The increase for Standard Mail Flats was under the Postal Service's self-imposed mark — Standard Mail average x 1.05. Nevertheless, the Commission approved the Postal Service's price increase.

G. Docket No. ACR2013

The Postal Service at long last did something to comply with the Commission's FY 2010 ACD directive in this docket — but only in part. The Postal Service provided one aspect of the information required, *i.e.*, the update to the schedule of above-average price increases. *See* FY 2013 ACR, p. 19. However, the Postal Service still refused to provide the required information related to (i) operational changes, (ii) costing methodology improvements, and (iii) the historical and estimated timeline for phasing out the subsidization of Standard Mail Flats. The Commission, once again, was forced to ask the Postal Service for this information in a Chairman's Information Request.

In the Postal Service's response to the information request, it explained several steps taken to improve the efficiency of handling Flats, but stated, "[n]o analysis has been performed to isolate the cost savings resulting from these initiatives...." *See* Postal Service Response to ChIR No. 2, Q. 1 (Jan. 23, 2014). Additionally, it listed three costing methodology changes were implemented during FY 2013, but "the effects of the changes were minimal." *Id.* Finally, the Postal Service described the cost coverage improvements that had occurred in FY 2013, and "predict[ed] that similar progress will be made in the upcoming year." *Id.*

The Commission's ACD concluded that "*no further remedial action is required at this time*." FY 2013 ACD, p. 54. *See* Section III.C for a detailed review of the Commission's analysis and conclusion.

H. Docket No. ACR2014 (pending)

The Postal Service's FY 2014 ACR once again presented a table of "Planned Standard Mail Flats Price Increases," consisting of CPI x 1.05 in 2015 and 2016. *Id.*, p. 20. Although the Postal Service did not file the other information required by the FY 2010 ACD directive, at least it noted in a footnote that it was not filing that information on time: "due to the unavailability of critical operations staff during the peak holiday mailing season, the Postal Service was unable to complete this analysis in time for today's filing. The Postal Service will provide this information to the Commission as a supplement to today's filing sometime in early January." FY 2014 ACR, p. 19 n.7.

The Commission's Order opening the annual compliance review ordered the Postal Service to file the delayed information no later than January 5, 2015. Order No. 2313 (Dec. 31, 2014), p. 4. The Postal Service filed it on January 15, 2015.

Again, the Postal Service went through the motions of responding to the FY 2010 ACD directive, but only provided superficial information. It listed three costing methodology changes which increased the costs of Standard Mail Flats slightly, but the Postal Service stated that "the effect of the changes were minimal." Supplemental Information (Jan. 15, 2015), p. 2. Furthermore, the Postal Service made no effort to "predict when the shortfall for Standard Mail Flats will be phased out." *Id.*, p. 3. The Postal Service also outlined some operational initiatives to reduce costs, but "[n]o analysis has been performed to isolate the cost savings resulting from the above initiatives…" — even though unit costs increased over 9 percent in FY 2014. *Id.*, p. 4. Notably, the Postal Service confirms Valpak's assertion in Docket No. ACR2013 that the Postal Service has wrung out of the system most of the costs that it can: "With the deployment of FSS machines now fully completed, the Postal Service's cost savings efforts are primarily focused on making more Flats and Periodicals mail available for FSS processing." *Id.*

The Commission thus far has not asked the questions Valpak proposed in any information request.

I. Docket No. R2015-4 (pending)

On January 15, 2015, the Postal Service filed a Notice of Market-Dominant Price Adjustment with a planned implementation date of April 26, 2015. The class-based price adjustment authority is 1.966 percent, and the Postal Service is proposing to increase Standard Mail Flats by an average of 2.466. Despite the FY 2010 ACD directive, the Postal Service's entire analysis of Standard Mail Flats consists of one paragraph:

> In this price adjustment, Flats receive an above average price increase. In its 2010 Annual Compliance Report, the Postal Service proposed a three year schedule of above-average CPI increases for Flats, which the Commission approved in its 2012 Annual Compliance Determination. In that schedule the Postal Service agreed to increase Standard Flats prices by at least CPI x 1.05 in 2014, 2015, and 2016. The increase proposed in this filing more than complies with that schedule, by increasing flats by CPI x 1.254 (Factor 2). [Postal Service Notice, pp. 23-24 (footnotes omitted).]

The Postal Service failed to file any of the FY 2010 ACD required information, and on January 23, 2015, Valpak filed a motion for issuance of an information request, asking the Commission to order the Postal Service to file that information. On January 27, 2015, the

Commission issued Chairman's Information Request No. 3, which included most of the questions Valpak asked be posed in the context of Docket No. R2015-4 (Q. 9, *infra*), as well as one question which Valpak asked be posed in the context of the Annual Compliance Review (Q. 10, *infra*):

> 9. Pursuant to the Commission's directives in its FY 2010 Annual Compliance Determination at 107, please provide:
> a. An explanation of how the proposed prices for Standard Mail Flats will move the cost coverage for Standard Mail Flats towards 100 percent.
> b. A statement estimating the effect that the proposed prices will have in reducing the subsidy of the Standard Mail Flats product.
> c. All underlying workpapers and data used to respond to parts a and b.
>
> 10. In its FY 2014 ACR, the Postal Service reports that the revenues for only two Standard Mail products did not cover attributable costs in FY 2014: Standard Mail Flats and Standard Mail Parcels. FY 2014 ACR at 17-19. In this docket, the Postal Service proposes approximately a 2.5 percent increase for Standard Mail Flats and approximately a 9.8 percent increase for Standard Mail Parcels. Notice at 21. Please explain why Standard Mail Parcels users can sustain a 9.8 percent increase, while Standard Mail Flats users can only sustain a 2.5 percent increase.[60]

Valpak also asked the Commission to ask one further (recurring) question, which was not included in ChIR No. 3:

> Please explain why the information required by the Commission in its FY 2010 ACD was not provided in the Postal Service's Notice of Market-Dominant Price Adjustment (Jan. 15, 2015). [Valpak Motion for Issuance of Information Request (Jan. 23, 2015).]

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[60] Responses to these questions have not been filed as of the filing of these Initial Comments, but Reply Comments will address the Postal Service's responses.